LEGISLATIVE PROPOSALS RELATING TO SECTION 280A AND OTHER MINOR TAX BILLS

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

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LEGISLATIVE PROPOSALS RELATING TO SECTION 280A AND OTHER MINOR TAX BILLS

MONDAY, OCTOBER 19, 1981

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

The subcommittee met at 10:10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman STARK. Good morning.

This morning the subcommittee is considering a number of miscellaneous bills and issues, including legislative proposals relating to code section 280A. It is the first hearing conducted by the subcommittee in this Congress in which various minor tax bills will be considered.

I believe we can provide an appropriate forum for the orderly consideration of bills and issues, many of a technical nature, making improvements to the Internal Revenue Code or limited in the scope of relief they afford.

Because of this, the subcommittee has the duty to carefully examine such legislation to insure that the changes advocated are desirable from a tax policy standpoint and further, that they do not unnecessarily complicate the tax code with narrow rules of limited application.

This hearing offers the opportunity for that careful review.

At this time I would like to note a few procedural rules which have been established for the subcommittee's hearing.

First, witnesses must summarize their statements rather than read them in full.

Second, I would limit the witnesses' summaries to 5 minutes.

It may be if members of the subcommittee wish to elicit further information from the witnesses during their inquiries, they may, but the initial statement should be limited to 5 minutes as we will attempt to limit members of the committee to that same time in the interest of proceeding rapidly.

At this point, without objection, the press release announcing this hearing will be made part of the record.

[The press release follows:]

[Press Release of Oct. 7, 1981]

HON. FORTNEY H. (PETE) STARK (D., CALIFORNIA), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A PUBLIC HEARING ON LEGISLATIVE PROPOSALS RELATING TO SECTION 280A AND OTHER MINOR TAX BILLS TO BE HELD ON MONDAY, OCTOBER 19, 1981

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a public hearing on legislative proposals relating to section 280A of the Internal Revenue Code and other minor tax bills on Monday, October 19, 1981. The hearing will be held at 10:00 a.m. in 1100 Longworth House Office Building, the Committee's main hearing room.

The lead-off witness at the hearing is expected to be the Honorable John E. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury.

BACKGROUND INFORMATION ON SECTION 280A

Section 280A of the Internal Revenue Code, enacted as part of the Tax Reform Act of 1976, disallows the deduction of certain expenses incurred in connection with the use of the taxpayer's home in a trade or business or income-producing activity or in connection with the rental of vacation homes and other residential real estate. The limitations of this section were intended to replace the vague standards on which courts and the Internal Revenue Service differed with more definitive, objective statutory tests for determining the deductibility of expenses.

Personal Use of Residence.—Section 280A limits the amount a taxpayer may deduct for expenses attributable to the rental of a dwelling unit if the taxpayer uses the unit for personal purposes in excess of a specified period of time during a taxable year. Use for personal purposes is defined, in part, to include use of the dwelling unit for personal purposes by the brothers, sisters, spouse, ancestors, or lineal descendants of the taxpayer or other owners.

This rule has resulted in the denial of deductions for the expenses of renting a residence to relatives even when a fair rental is charged.

In addition, under proposed Treasury regulations published on August 7, 1980 in the Federal Register (45 Fed. Reg. 52399), personal use of the dwelling unit would also include days where individuals are present on the premises and are not engaged in repairs and maintenance on a substantially full-time basis.

Business Use of Home.—Section 280A permits the deduction of expenses attributable to a portion of a taxpayer's residence which is exclusively used on a regular basis as the taxpayer's principal place of business.

Under the proposed Treasury Regulations, the taxpayer's "principal place of business" would be defined as the principal place of the taxpayer's overall business activity. A taxpayer would have only one principal place of business regardless of the number of business activities in which the taxpayer is engaged. This result is contrary to a recent Tax Court case, *Curphey* v. *Commissioner*, 73 T.C. 766 (1980), which allowed a hospital-employed dermatologist to deduct expenses for a home office which was the principal place of business for his real estate rental business.

Prior Action.—Congress last year imposed a moratorium on the implementation of the proposed regulations as part of H.J. Res. 610, providing for further continuing appropriations, through December 15, 1980. However, the statutory moratorium was not extended in light of the Treasury Department's announcement that the regulations would not become final before July 1, 1981 at the earliest.

Several bills were introduced late in the 96th Congress to amend section 280A to reverse the above results. These and similar bills have been re-introduced in the 97th Congress, including H.R. 588, H.R. 890, H.R. 1177, H.R. 1280, H.R. 1410, and H.R. 4071.

In addition, testimony is invited on the following expiring provision and minor bills:

1. *Section 9(e), Public Law 96-167.*—Relating to the December 21, 1981 termination of the postponement of the effective date for special limitations on net operating loss carryovers (Code section 382), which were enacted in the Tax Reform Act of 1976.

2. *H.R. 2295 (Mr. Downey, Mr. Porter, Mr. Ottinger, and Mr. Pickle).*—To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of educational filmstrips.

3. *H.R. 2397 (Mr. Holland).*—To amend the Internal Revenue Code of 1954 with respect to the treatment of certain lending or finance businesses for purposes of the tax on personal holding companies.

4. *H.R. 2860 (Mr. Stark).*—To amend the Internal Revenue Code of 1954 with respect to the limitation on the acceleration of the accrual of taxes.

5. *H.R. 4408 (Mr. Schulze, Mr. Vander Jagt, Mr. Brodhead, and Mr. Heftel).*—To amend the Energy Tax Act of 1978 to allow certain additional refunds relating to the repeal of the excise tax on buses.

6. *H.R. 3581 (Mr. Russo).*—To amend the Internal Revenue Code of 1954 to exclude certain foreign commodity income from treatment as foreign personal holding company income.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony at the hearing should submit their requests to be heard by telephone to be followed by a formal written request, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515; telephone: (202) 225-3627. The initial telephone request must be received by the Committee not later than the close of business Wednesday, October 14, 1981. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

PROCEDURES TO BE FOLLOWED FOR SUBMITTING TESTIMONY

The following is an outline of the procedure to be followed by organizations and individuals who may either want to appear and testify during the hearing or file a written statement for the printed record of the proceedings. All requests to be heard should also contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).

2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.

3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee should comply with the following rules:

1. All witnesses must submit 40 copies of their prepared statement to the full Committee office, Room 1102, Longworth House Office Building, not later than noon on Friday, October 16, 1981.

2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.

3. Not more than five minutes will be allowed for the oral summary.

Failure to comply with these requirements may result in the witness being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing five copies are required and must be submitted by the close of business, Friday, October 30, 1981. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office the day before the hearing.

Chairman STARK. We are pleased to have as our first witness this morning Hon. John E. Chapoton of the Department of the Treasury.

Buck, it is my understanding you are going to go through all of the bills that are before us initially and give us Treasury's summary.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. That is correct, Mr. Chairman.

Chairman STARK. I would like to yield to Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Again may I say the Republican Members of the subcommittee are looking forward to working with you on the many issues we will have before the committee.

As you know, section 280A was enacted to clarify prior law. In practice, however, it has created additional problems for taxpayers and the Treasury. For the most part these problems result from the many situations that section 280A covers. To fully implement the statute, detailed and sometimes complicated rules are required. In addition, supporting records must be obtained. This hearing, I think, will provide the subcommittee and the full committee with an opportunity to consider proposals that will make the statute more workable. This will benefit the taxpayers and the Treasury.

You are to be commended for holding this timely hearing.

Chairman STARK. I thank the gentleman.

If there are no further comments, I will ask Mr. Chapoton to proceed.

Mr. CHAPOTON. Thank you, Mr. Chairman.

I am going to summarize all the bills. If I might go a bit over 5 minutes, as much as 10 minutes, would that be permitted?

Chairman STARK. I think we can interpret the rule to mean that you might have almost as much as a couple of minutes per bill.

Even 5 minutes for the more complicated ones.

Mr. CHAPOTON. Thank you, Mr. Chairman.

The first bill or bills I would like to discuss relate to the section 280A issues Mr. Duncan mentioned. Section 280A was enacted in 1976. Regulations were published on August 7, 1980.

The three questions that have been raised by these regulations are:

First, what is the appropriate tax treatment when a dwelling unit is rented to a family member at fair rental value.

The second is whether a taxpayer should be permitted to take a deduction allocable to a portion of a dwelling unit used exclusively on a regular basis as the principal place of business for a secondary business of the taxpayer.

The third issue is when a day of use of a vacation home should be considered for repair and maintenance and therefore not personal use.

The first issue must be handled by further legislation.

The latter two we are going to deal with in the regulations as I will mention and we think further legislation is not necessary.

Turning to the first issue, the statutory scheme, as you know, is that if a dwelling unit is used for personal purposes for more than the greater of 14 days or 10 percent of the days in the year during which the unit is rented at a fair rental value, then no deductions in excess of the income from the unit are allowed, except deductions which would be available in any event, that is, taxes and interest.

It is clear that, under the current statute, renting the unit to a member of the taxpayer's family, that is, spouse, brothers and sisters, lineal descendants and the like, even at fair rental, is considered personal use.

The issue is whether a taxpayer should be permitted to deduct depreciation and similar expenses of a dwelling unit in excess of

his income from the unit when the rental is to a family member. He can clearly do so if it is rented at fair rental to an unrelated party and under the statute can clearly not do so if it is rented to a family member.

This is a close question. I discuss some of the issues in our written statement. The problem is that a family is often a single economic unit and therefore the feeling underlying the legislation was obviously that you should not be able to generate deductions in excess of income from a rental within a family. The principle is similar to the principle underlying section 267 of the code which prevents losses from being deducted when the property is sold within a family.

On the other hand, where property is in fact rented at a fair rental value, it seems harsh to apply a more strict test even though the rental is to a family member.

Thus, we would not oppose making the change which is made in several of the bills before the subcommittee this morning which would allow deductions with respect to a dwelling unit rented to a family member provided the rental is at a fair rental value.

However, we think the legislative history should make it clear that dealings between family members in this context will be closely scrutinized. It should also be made clear that if the owner-lessor, continues to use the property, then it would be considered personal use, notwithstanding that fair rental is, in fact, paid.

Finally, if substantial gifts are made around the time of the lease at a fair rental value, then the gifts should be taken into account in determining whether or not there is in fact a fair rental paid.

As I stated earlier, this issue would have to be handled in legislation.

The second issue is the case in which a home office is used as a principal place of business for a secondary business. The proposed regulations currently provide that a taxpayer may have only one principal place of business.

We think that probably is too harsh and we are changing the regulations to provide that if a home office is the principal place of business for a secondary business, then the home office expenses of that second place of business will be deductible provided that the place of business—the room in the home, for example—is used exclusively and on a regular basis as the principal place of business of the secondary business.

There will be some administrative problems caused by this rule but we think on balance it is better, more fair and, keeping in mind that the deductions cannot exceed the income from the secondary business, we think there is not a significant problem of abuse here.

The final question under the regulations is the repair and maintenance day provision. The proposed regulations took the position that a dwelling unit is considered to be used for personal purposes if the owner performs repair and maintenance work but he is accompanied by other able-bodied persons who could work on the dwelling unit and do not do so.

There are serious administrative problems in determining what the purpose of the visit is and what the purpose of the presence of

other persons with the taxpapers at the time of the so-called repair and maintenance day is.

In the changed regulations, we are going to say that a day I use is a repair and maintenance day if the principal purpose of the use is for repair and maintenance. That will have to be resolved on a case-by-case basis, but it does set forth the issue, that is, whether the principal purpose of the use is for personal use or is for repair and maintenance.

We will be coming forth with the regulations on these two issues, we think, in a month, maybe a little sooner.

The regulations have been prepared in final draft form and are now proceeding for signature.

Chairman STARK. Excuse me.

Can you give me an idea of when those regulations will be published?

Mr. CHAPOTON. I would think, Mr. Chairman, in about a month or sooner. They have been completely drafted and are being circulated for final signature within the IRS now.

Chairman STARK. Thank you.

Mr. CHAPOTON. I should mention——

Chairman STARK. Issued as a proposed regulation?

Mr. CHAPOTON. Issued as a proposed regulation, yes, sir.

I would just mention that one of the bills before you, H.R. 4071, would deal with the case where two individuals own a residence and one lives in it and pays the other the fair rental value of the residence.

We would have no problem with that change. There are technical problems in that proposed change which are outlined on page 11 of my testimony which we want corrected there.

I would like to switch to the question of deferral of the effective date of the amendments made by the Tax Reform Act of 1976 to sections 382 and 383 of the code. These provisions deal with limitations on net operating loss and investment tax credit carryovers in taxable acquisitions of a business or tax-free acquisitions of a business.

The rules have been in the law for some time. It is generally felt that these limitations can be avoided by well-advised taxpayers and that they should be tightened. Although this was done in 1976, the complexity of the changes and the technical problems that they caused led Congress to defer the effective date of the amendments. These amendments are now scheduled to become effective beginning on January 1 of next year.

We think that another 2 year deferral of the effective date is appropriate. We do not want to kill those provisions, but we do want to defer them so we can have further time to try to work out the complexities and issue rules in advance of the effective date.

The next issue is H.R. 2295, which would extend the investment tax credit to educational film strips. This involves an expansion of section 48(k) of the Internal Revenue Code.

Section 48(k), added to the code in 1976, attempted to resolve an ongoing controversy concerning whether movies and television films qualify for the investment tax credit. Accordingly, section 48(k) was a carefully crafted provision reflecting a compromise between the general rule that the credit is limited to tangible

personal property—that is, is denied to intangibles such as patents and copyrights—and court decisions holding that in certain contexts movies and television tapes do qualify for the credit.

48(k) sought to lay those questions to rest for the past and future. Now we come to the not surprising second question of whether a qualified film might also include an educational film strip. A film strip, unlike a movie or video tape, does not show a moving image, but rather is a series of still pictures. It is true, unquestionably, that film strips do closely resemble eligible films. It is also true they closely resemble slides and—by extension—photographs, for which no credit is allowable.

On examination of this issue at length, we decided that we should oppose this provision. If the credit were allowed for film strips, it would unquestionably be argued that we should go the second, third, and fourth steps. For example what about additional educational materials that are also very deserving, books and records used in the school, for example? Should these not also be credit-eligible?

Also the same logic could be applied in the entertainment area since section 48(k) applies to movies and video tapes used for entertainment as well as for educational purposes. The argument would certainly be made that slides and photos, and indeed lithograph plates and other works of art, used for entertainment purposes should likewise qualify for the credit.

We think, quite frankly, Mr. Chairman, if the law were to be changed in this area, it should have to go in the opposite direction; having extended the credit beyond its original purpose, we do not think it should be extended further.

I would also point out we have significant problems in the tax shelter area with respect to the application of the credit to intangibles. In the recording industry, for example, promoters are taking the position in tax shelter offerings, that the credit applies to the entire cost of producing the master record.

We hope that the subcommittee and the Congress would support our efforts to prevent extension of the credit in these areas.

Chairman STARK. I would comment the Chair does. I won't speak for the rest of the members.

Mr. CHAPOTON. We appreciate that, Mr. Chairman.

The next bill before you, H.R. 2397, relates to lending or finance companies and the question has to do with the personal holding company rules. H.R. 2397 would make two changes. It first would tighten the eligibility for being classified as a personal holding company or avoiding the classification of a personal holding company by reason of being a lending or finance company.

It would tighten it, as I say, by increasing the amount of business expenses that you must have to qualify as a lending or finance company. We support this change. It would also loosen the definition of a lending or finance company by extending the period of time over which loans could be made from 5 years to 12 years and still qualify.

We would not oppose the second loosening provision provided that the other change, tightening the current provisions, were also made at the same time.

We think that if the expenses are such that it does show that the lending of a finance company is actually engaged in the lending or finance business and the entire operation is not an incorporated pocketbook, these would be good changes.

Chairman STARK. It occurs to me that most States define a finance company, either personal property brokers or—in many of the States, different time limits, whether it is a 12-year loan, a 6-year loan. Would there be any desirability——

Mr. CHAPOTON. To follow the State's definition?

Chairman STARK. In getting a little bit different definition? If somebody is licensed to operate under the laws of a State, does that become a possible definition for Federal income tax purposes?

Mr. CHAPOTON. That might well put pressure on those laws that we woudn't want.

We have reviewed this. Indeed, we think the length of the loan or those types of considerations are not so important as the fact that you have and do incur—that you have major expenses incurred in carrying on this business.

Once you do that, it seems to us that you are indeed in the operation of the business.

The problem here, of course, is that a personal holding company—the personal holding company's provisions are designed to prevent the incorporated pocketbook that avoids the higher rates at the individual level.

We think if you have the significant expenses that pretty well avoids the problem. It means you are a lending or finance company.

H.R. 2860 relates to accrual of State taxes. It would amend section 461(d) which says that if the State changes its law to allow an earlier accrual of State taxes, then you do not accelerate the deduction, even though, under the State law, the deduction would accrue earlier. The logic of the provision as originally enacted was to prevent corporations from receiving a double deduction in the year of change.

The California franchise tax was changed in 1971, effective in 1972, to require payment of a franchise tax for a company going out of business. The provision made a lot of sense, but it did have the effect of accelerating the date of accrual of the franchise tax. We do not oppose a provision allowing the earlier deduction provided the suspense account mechanism is used to prevent a double deduction in the year of the change. That mechanism has come into common use since section 461(d) was enacted. We think that the suspense account mechanism would preclude a double deduction and indeed make the understandable change in the California law appropriate for tax purposes as well.

Chairman STARK. You recognize that in the manner in which we compute revenue loss or gain, this appears as a relatively large revenue loss. It is merely, if I understand it correctly, a sort of postponement forever of that 1-year catchup, which means that we bounce along with the loss, but we always get it the next year?

Mr. CHAPOTON. That is correct.

Chairman STARK. When the world ends?

Mr. CHAPOTON. When the world ends, the deduction will finally be available because you will have——

Chairman STARK. My reputation as a fiscal conservative is on the line in this bill.

Mr. CHAPOTON. I know. It would, I think, have been considered when section 461(d) was enacted if we had had the suspense account mechanism, as you say, to make that additional deduction bounce along until the corporation goes out of business. Then it will be available. It is a mechanism used commonly in the code now and seems to be very appropriate here.

H.R. 3581 relates to foreign commodity income. It would exclude from subpart (f) income dividends distributed from one foreign sub to another foreign sub of a U.S. corporation if the dividends are attributable to dealings in agricultural commodities not grown in the United States in commercial quantities.

The logic of this proposed amendment is that commodity trading income of a foreign subsidiary was exempted in 1976 from subpart (f) income and the question is raised why isn't it appropriate also to exempt from subpart (f) income dividends coming out of those profits.

Our answer is that we think it is not appropriate. There are many cases in which a foreign subsidiary may engage in business activities not resulting in subpart (f) income, but when that subpart (f) income is distributed from one foreign sub to another, the dividends are treated as subpart (f) income.

The basic policy of the controlled foreign corporation legislation is that a U.S. controlled CFC should not be able to transfer funds not previously subjected to U.S. tax so as to benefit the U.S. parent without the imposition of a U.S. tax at the time of the distribution.

This is a sound policy, we think, and it is applied except in very limited circumstances to all dividends in that context.

We see no reason to deviate from that policy here.

Chairman STARK. Mr. Secretary, it is my understanding in the case at point that if the two companies were merged, the problem would cease to exist.

Mr. CHAPOTON. That is correct.

Chairman STARK. So there are——

Mr. CHAPOTON. There are ways——

Chairman STARK [continuing]. Structural ways to accomplish the same end without getting into the tax code?

Mr. CHAPOTON. That is correct. There are problems in the particular case in which this is presented in following that route, but our basic point is that the treatment of dividends paid in this case is consistent with the policy of subpart (f) income and we don't think an exception should be made here.

Finally, H.R. 4408 deals with the refunds on excise taxes on buses.

The excise tax was repealed by the Energy Tax Act of 1978. Under the refund procedure set up in that act, the manufacturer was required to reimburse the purchaser prior to receipt of a refund from the IRS. This mechanism obviously is designed to insure that the refund actually goes to the purchaser and doesn't stop with the seller of the buses.

In the case of the particular manufacturer in Pennsylvania, it was unable to make the refund because of financing problems prior

to the deadline set in the legislation and thus was not able to obtain the refund from the IRS.

We would not object to the procedure contained in H.R. 4408 that would allow the refund to the manufacturer in this case provided that the IRS approve the actual reimbursement procedure, to make certain that the refund does actually get to the purchaser of the buses.

Also, as stated in our testimony, since this is special relief legislation and is retroactive, we do not think it would be appropriate to pay interest on the refund. Simply by allowing the refund we think Congress would be going quite far enough in this special situation.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. Chairman and members of this subcommittee, I am pleased to appear before you to express the views of the Treasury on several bills dealing with section 280A of the Internal Revenue Code, which limits the deduction of certain expenses relating to the use of the taxpayer's home or other residential real estate including vacation homes. In addition, I will also state Treasury's views on several other matters under consideration by this Subcommittee.

SUMMARY

Section 280A issues

H.R. 588 would provide that a dwelling unit would not be considered as used for personal purposes if it is used by a member of the taxpayer's family and the unit is rented to the family member at fair rental; the family member is aged 60 or older; or the family member is permanently and totally disabled. The Treasury Department opposes H.R. 588.

H.R. 890 would postpone the effective date of section 280A. The Treasury Department opposes H.R. 890.

H.R. 1177 would treat the rental of a dwelling unit at fair rental to a family member in the same manner as a rental to an unrelated third party if the family member uses the unit as his or her principal place of residence. H.R. 1290 and H.R. 1410 would apply the same rule whether or not the family member uses the unit as his or her principal place of residence. Subject to certain qualifications, the Treasury Department does not oppose H.R. 1177 and these sections of H.R. 1290 and H.R. 1410.

H.R. 1290 and H.R. 1410 would also allow a taxpayer to take home office deductions, subject to certain limitations, for the portion of a dwelling unit exclusively used on a regular basis as the principal place of business for a secondary trade or business of the taxpayer. The Treasury Department agrees with this change and intends to make it by regulation.

H.R. 1290 would also alter the rules concerning when a dwelling unit is considered to be used for repair and maintenance. Because the rules in the current proposed regulations relating to repair and maintenance days will be changed by regulation, the Treasury Department opposes this section of H.R. 1290.

H.R. 4071 would alter the rules concerning the applicability of section 280A to a co-owner of a dwelling unit when a fellow co-owner uses the property as his or her principal residence under a rental of the unit at fair rental rates. Although the Treasury Department does not object to the goals of H.R. 4071, we have technical problems with the bill as drafted.

Other matters

Modifications to the limitations on net operating loss carryovers and credit carryovers that were enacted in the Tax Reform Act of 1976 are scheduled to become effective in 1982. The Treasury Department supports a further 2-year deferral of the effective date of the 1976 amendments.

H.R. 2295 would allow the investment tax credit for investment in "educational filmstrips." The Treasury Department opposes H.R. 2295.

H.R. 2397 would tighten the rules for determining whether a corporation qualifies for the "lending or finance company" exclusion from the personal holding company rules. The Treasury Department supports these changes. H.R. 2397 would also broaden the definition of a "lending or finance business" by increasing the maturity

and types of eligible loans for such a business. The Treasury Department does not oppose these provisions of H.R. 2397 provided that the business expense eligibility test is tightened at the same time.

H.R. 2860 would allow taxpayers on the accrual method of accounting to deduct state taxes in the proper year of accrual even if the date of accrual is accelerated under state law. This election would be permitted only if the taxpayer agrees to establish a suspense account to prevent the realization of a double deduction in the year that the election is made. The Treasury Department supports H.R. 2860.

H.R. 3581 would exclude from the definition of foreign personal holding company income dividends paid by a controlled foreign corporation which derives at least 80 percent of its gross income from the purchase or sale of agricultural commodities not grown in the United States in commercially marketable quantities. The Treasury Department opposes H.R. 3581.

H.R. 4408 would provide a new procedure for claiming a refund for the excise tax on buses which was repealed by the Energy Tax Act of 1978. The Treasury Department does not object to H.R. 4408 other than the provision that provides for the payment of interest on the refund, which the Treasury Department opposes.

SECTION 280A ISSUES

Section 280A generally limits deductions with respect to a dwelling unit used as a residence. Proposed regulations under section 280A were published in the Federal Register on August 7, 1980. Three issues posed by these proposed regulations have engendered particular interest:

(i) the tax treatment under section 280A when a dwelling unit is rented to a family member at fair rental;

(ii) whether a taxpayer should be permitted to take deductions allocable to a portion of a dwelling unit exclusively used on a regular basis as the principal place of business for a secondary business of the taxpayer;

(iii) when a day of use of a vacation home should be considered "repair and maintenance" use and therefore not personal use.

I would like to address each of these issues today.

Rental to family members.—If a taxpayer uses a dwelling unit for personal purposes for more than the greater of 14 days or 10 percent of the number of days that the unit is rented at fair rental, then the deductions attributable to the rental of the unit are limited, in general, to the gross income from such rental reduced by deductions (such as interest and certain taxes) allowable without regard to how the unit is used. Personal use for this purpose includes renting the unit to a member of the taxpayer's family (i.e., spouse, brothers, sisters, ancestors and lineal descendants), even at fair rental.

It has been urged that the rental of a dwelling unit to a family member at fair rental should be treated in the same manner as the rental of the unit to unrelated parties. This is a change that must be made by statute (and not by regulation). Three bills before this Subcommittee—H.R. 1290, H.R. 1410 and, a slightly modified way, H.R. 1177—would make this change. Our views on this issue are as follows.

Under the present version of section 280A, if a taxpayer rents a dwelling unit to a family member at fair rental, then, in general, the taxpayer can use the allocable rental deductions (e.g., depreciation, utilities) to offset the income from the unit, but the taxpayer cannot use these deductions to generate a loss to be used to offset the taxpayer's income from other sources. Thus, the issue is whether a taxpayer should be permitted to deduct depreciation (and similar expenses) on a dwelling unit rented to a family member even to the extent a deductible loss results, a result available if the taxpayer rented to an unrelated party.

This is a very difficult issue. On the one hand, it seems only fair that the owner of a dwelling unit should get the same tax advantages when renting to a family member at fair rental as when renting to an unrelated third party.

On the other hand, a family is often a single economic unit. It seems that one should not be able to generate losses from depreciation deductions simply by renting the unit within one's family if, in reality, the family is a single economic unit. For similar reasons, section 267 of the Code prevents taxpayers from deducting losses when property is sold within a family.

The issue boils down to whether the unfairness created by denying rental losses generated by depreciation deductions when family members are truly dealing at arm's length outweighs the tax avoidance that might occur when such losses are created in rental transactions within families which are essentially a single economic unit. On balance, we believe there are situations where persons do deal at arm's length in rental transactions with their family members and where allowing the deduction of rental losses is accordingly appropriate. Moreover, the main oppor-

tunity for tax avoidance through intrafamily rentals arises only where the annual depreciation deduction (and similar expenses) exceed the annual rental paid.

Thus, we do not oppose making this change legislatively provided it is made clear in the legislative history that transactions between family members will be scrutinized closely to ascertain whether their terms are truly fair market terms. It should also be made clear that if the owner continues to make use of the property, this will be personal use regardless of the rental arrangements. In addition, the statutory language or legislative history should provide that a rental will not be considered a fair rental if substantial gifts are made from the lessor to the lessee. The reason for such a provision is that a rental arrangement cannot be considered to be at fair market terms if the lessor provides the lessee with a gift of funds which substantially offsets the rent.

Home offfice used as principal place of secondary business.—In general, section 280A disallows deductions in connection with the use of part of a residence for business purposes except in certain specified situtations. Under one of these exceptions, a taxpayer may take certain deductions allocable to a portion of a dwelling unit which is exclusively used on a regular basis as the taxpayer's principal place of business. Under the present statutory language, it is not clear whether (i) a taxpayer can have a principal place of business for this purpose for each trade or business in which the taxpayer engages or (ii) a taxpayer can have only one principal place of business—the principal place of his overall business activity—regardless of the number of trades or businesses in which the taxpayer engages.

The proposed regulations under section 280A provide that a taxpayer can have only one principal place of business regardless of the number of trades or businesses in which the taxpayer is engaged. On the other hand, a Tax Court case, *Curphey* v. *Commissioner*, 73 T.C. 766 (1980), holds that a taxpayer may, for this purpose, have a principal place of business for a secondary trade or business.

Two bills before this Subcommittee—H.R. 1290 and H.R. 1410—would allow deductions, subject to certain limitations, allocable to a portion of a dwelling unit which is exclusively used on a regular basis as "a principal place of business for any trade or business of the taxpayer." This would enable a taxpayer to take home office deductions, subject to certain limitations, allocable to a portion of a dwelling unit which is exclusively used on a regular basis as the principal place of business for a secondary trade or business of the taxpayer.

We agree for several reasons that a taxpayer should be able to take home office deductions, subject to certain limitations, allocable to a portion of a dwelling unit which is exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer i.e., including a secondary trade or business.

First, assuming that the rule can be administered in an effective manner, it would seem fair that a person who earns most of his or her income from a regular office job but who also conducts a separate trade or business out of the home should be able to deduct home office expenses with respect to a portion of the home used exclusively on a regular basis as the principal place of the secondary business.

Second, limitations on home office deductions were enacted to reduce the administrative problems that arise where residences are used for both business and personal purposes, since it is difficult to substantiate the amount of time spent for each of these uses. In this regard, the purpose of the "principal place of business" requirement appears to be to provide a reasonably verifiable threshold of business activity that must be carried on in a home office before home office deductions with respect to the activity may be taken. For example, this requirement rules out home office deductions for a taxpayer who maintains a regular office at his or her employer's place of business but uses a portion of his or her home for doing office work at night or on weekends. Although there may be some administrative difficulties in determining what constitutes a trade or business, we believe that, on balance, to require a home office to be used as the principal place of business for a trade or business of the taxpayer will provide a sufficiently verifiable threshold of business activity for administrative purposes.

Third, the amount of any home office deductions would remain limited, in general, to the gross income derived from the use of the home office in the secondary business, reduced by deductions (such as interest and certain taxes) which are allowable without regard to the use of the residence. Thus, taxpayers would not be able to take large home office deductions in respect of minor business activities (perhaps bordering on hobbies) even if these activities were dubbed "trades or businesses."

On balance, we believe that allowing a taxpayer to take deductions allocable to a portion of a dwelling unit exclusively used on a regular basis as the principal place of a secondary business will cause some additional administrative problems, but that these problems are manageable in view of the strong fairness argument for

allowing such deductions. Thus, we agree with this change and we intend to make it by regulation. Accordingly, a statutory change is not necessary.[1]

Repair and maintenance days.—Section 280A directs the Secretary of the Treasury to prescribe regulations with respect to the circumstances under which use of a dwelling unit for repairs and annual maintenance will not constitute personal use. The proposed regulations provide in general that if, for a particular day, a taxpayer is engaged in repair or maintenance work on a substantially full-time basis but accompanyng individuals who are capable of working on a substantially full-time basis do not do so, then the day will be considered a day of personal use.

One of the bills before this Subcommittee—H.R. 1290—would reverse this result by providing that, notwithstanding any ruling, proposed regulation or regulation to the contrary, a dwelling unit will not be treated as used by the taxpayer for personal purposes on a day on which the taxpayer is engaged in repair or maintenance work on the unit on a substantially full-time basis because other individuals on the premises on that day who are capable of working do not work on the unit on a substantially full-time basis.

We feel some sympathy for the result reached by H.R. 1290 when the clear purpose of a taxpayer's use of a vacation home is repair or maintenance but, for example, the taxpayer's spouse accompanies the taxpayer "for the ride." On the other hand, if three or four friends of the taxpayer also accompany the taxpayer, we think this should be considered a day of personal use by the taxpayer.

A more fundamental issue is presented by these various rules. Rules of this nature are difficult to enforce because there is no way to verify what the taxpayer actually did on a particular day. Moreover, honest taxpayers may feel aggrieved if they believe that dishonest taxpayers can easily avoid the rules.

In view of this limitation, we intend to follow a different approach in the regulations. Under this approach, a day of use would not be considered personal if the "principal purpose" of the use were repair and maintenance. Although this approach does not solve the verification problem, it reflects a recognition of the practical limitations on precise but unverifiable rules. In addition, it allows a more flexible consideration of the facts and circumstances involved in particular situations such as that described above.

Because the regulations are going to be changed, this provision of—H.R. 1290 is unnecessary. Indeed, since it does not provide an affirmative statement of a rule, it would serve primarily as a source of confusion. Therefore, Treasury opposes this provision.

Treasury positions on specific bills relating to section 280A

We would like to supplement the foregoing analysis of the section 280A issues with a brief statement of Treasury positions on the section 280A-related bills that are before this Subcommittee.

H.R. 588.—H.R. 588 would provide that a dwelling unit would not be considered as used for personal purposes if it is used by a member of the taxpayer's family and (i) the unit is rented to the family member at fair rental; (ii) the family member is aged 60 years or older; or (iii) the family member is permanently and totally disabled. In effect, this would mean that a taxpayer renting a dwelling unit to one of these types of family members would be able to use deductions in respect of the unit (including depreciation) not only to offset the rental income but also to offset income from other sources.

Treasury opposes H.R. 588. We believe that rentals of dwelling units to family members who are aged 60 or older or who are disabled should be treated the same as rentals to other family members. The tax law would become impossibly complex if every Code section were rewritten to provide special rules of this type.

H.R. 890.—H.R. 890 would postpone the effective date of section 280A from taxable years beginning after 1975 to taxable years beginning after 1981.

Treasury opposes H.R. 890. A postponement of section 280A after it has been in effect for five years would be unfair to the many taxpayers who have been comply-

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[1] If it is decided to proceed to make this change by statute, one important technical change should be made in the language of H.R. 1290 and H.R. 1410. Both bills would provide an exception to certain limitations of section 280A for certain deductions allocable to a portion of a dwelling unit which is exclusively used on a regular basis as "*a* principal place of business for any trade of business of the taxpayer." This should be changed to "The principal place of business for any trade or business of the taxpayer." The change would make it clear that a taxpayer may have only one principal place of business for each trade or business in which the taxpayer engages. If a taxpayer could have more than one principal place of business for a trade or business, then the tax law would be forced to resolve questions about home office deductions in connection with minor business uses of the home (such as home office deductions for the employee who takes work home at night)—precisely the questions that the enactment of section 280A was intended to eliminate.

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ing with it all along. If there are specific problems, these should be addressed, not be sidestepped by postponement.

H.R. 1177.—H.R. 1177 would treat the rental of a dwelling unit to a family member at fair rental in the same manner as the rental of the unit to an unrelated third party, but only if the family member uses the unit as the member's principal place of residence. Thus, if these conditions were met, deductions in respect of the unit (including depreciation) could be used not only to offset the income from the unit but also to offset income from other sources.

Treasury does not oppose H.R. 1177 subject to the conditions set forth in the last paragraph of the discussion entitled "Rental to Family Members."

H.R. 1290 and H.R. 1410.—H.R. 1290 and H.R. 1410 would treat the rental of a dwelling unit at fair rental to a family member in the same manner as the rental of the unit to an unrelated party. Treasury's position on these parts of H.R. 1290 and H.R. 1410 is the same as our position on H.R. 1177.

H.R. 1290 and H.R. 1410 would also allow taxpayers to take home office deductions, subject to certain limitations, allocable to a portion of a dwelling unit exclusively used on a regular basis as "a principal place of business for any trade or business of the taxpayer," i.e., including a secondary trade or business. As stated above, we agree with this change and intend to make it by regulation. Thus, this statutory provision is unnecessary.

Finally, H.R. 1290 (but not H.R. 1410) contains a provision relating to the rules on when a dwelling unit is considered to be used for repair and maintenance. As discussed in the section entitled "Repair and Maintenance Days", Treasury opposes this section of S. 1290.

H.R. 4071.—H.R. 4071 provides that if, under an agreement, (i) two or more persons acquire interests in a dwelling unit and (ii) one or more of the persons holding such an interest are entitled to use the unit as a principal residence and are required to pay fair rental (taking into account the occupant's ownership interest), then the section 280A limitations on deductions attributable to the rental of the unit shall not apply while the unit is rented in accordance with the agreement. This provision might apply, for example, if two individuals bought a residence, with each individual acquiring a one-half interest, and one of the individuals used the residence as his principal residence and paid fair rental for such use.

We agree as a policy matter that if A and B each acquire, for example, a one-half ownership interest in a dwelling unit and A uses the dwelling unit as his principal residence and pays fair rental to B, then B's ability to take deductions with respect to the rental of his interest in the property should not be limited by section 280A. However, we have some technical problems with the way H.R. 4071 is presently drafted:

(i) The term "shared equity financing agreement" is somewhat vague in its requirement that two or more persons acquire "interests" in the property. We agree that undivided ownership interests should qualify for this purpose. As for other types of interests, these should be spelled out and it should be decided independently whether their inclusion would be appropriate.

(ii) The provision should make it clear that only the non-resident co-owner receives relief from section 280A. The resident co-owner should remain fully subject to section 280A (e.g., if he were to sublet the unit for part of the year).

We stand ready to work with the Subcommittee in an effort to resolve these problems and any other potential technical problems that may arise.

EXPIRATION OF THE DEFERRAL OF THE EFFECTIVE DATES RELATING TO SPECIAL LIMITATIONS ON NET OPERATION LOSS CARRYOVERS (CODE SEC. 382)

The Tax Reform Act of 1976 amended sections 382 and 383 of the Internal Revenue Code. These provisions limit the ability of a corporation to claim the benefit of net operating loss carryovers and various credit carryovers if certain events occur. The principal condition required to bring these provisions into effect is that there be a sufficient change in identity of the stockholders of the corporation seeking to carry over the losses and credits. Prior to the 1976 amendment of these provisions, well-advised taxpayers could, in most instances, structure their acquisitions of loss corporations to avoid these limitations.

The 1976 amendments made it much more difficult to avoid the limitations of sections 382 and 383. In doing so, very complex provisions were enacted. Concern over the complexity of the 1976 amendments, as well as the presence of technical problems with the amendments, led Congress to defer their effective date. Unless a further delay is authorized, the new section 382 and 383 rules will be applied to plans of reorganization adopted after January 1, 1982 and to stock purchases occurring after June 30, 1982.

The Treasury Department supports an additional two year deferral of the effective dates of the 1976 amendments to sections 382 and 383. The technical problems present in the 1976 amendments have not yet been resolved. In addition, no regulations have been issued concerning the proper method of complying with the complex rules that would otherwise become effective. Substantial confusion is likely to result if the effective date were not further deferred.

We believe that a further deferral of the effective dates of the 1976 amendments would be preferable to continuing the existing limitations of section 382 on a permanent basis. Because the existing limitations can generally be avoided, continuing the existing limitations on a permanent basis would allow the well-advised to maintain loss and credit carryovers after almost all corporate acquisitions. Although several commentators have argued that unused net operating losses and credits should be freely transferable, we believe that this issue should be considered explicitly. The Treasury Department has not yet determined what limitations, if any, it believes should be imposed on the ability of a corporation to use net operating loss carryovers and credit carryovers in taxable years after a substantial change in identity of the corporation's stockholders.

H.R. 2295—Investment tax credit for educational filmstrips

H.R. 2295 would allow the investment tax credit for investment in "educational filmstrips." The bill would apply retroactively to taxable years beginning after December 31, 1974.

The Treasury Department opposes H.R. 2295.

To put the issues raised by this bill in perspective, I believe that some background may be useful.

Investment tax credit.

The investment tax credit was enacted in 1962 for the express purpose of encouraging modernization and expansion of our Nation's productive facilities, thereby increasing job opportunities for American workers and improving our competitive position in the world economy.[2] To achieve these goals the investment credit was generally limited to investment in machinery and equipment—durable property used in the production process.[3] No credit was allowed for buildings and their structural components. Similarly, the credit was not considered necessary or appropriate for investment in intangible assets such as patents or copyrights.

Movies and television films

Notwithstanding its inapplicability to intangible assets generally, the Congress and the courts have seen fit to allow the credit for the capitalized cost of producing movies and television films. Thus, relying largely on language in the legislative history of the Revenue Act of 1971, a series of decisions in the Ninth Circuit held that the master picture negatives and sound tapes constitute tangible personal property eligible for the credit. *Walt Disney Productions* v. *United States*, 480 F. 2d 66 (9th Cir. 1973), cert. denied, 415 U.S. 934 (1974); *Walt Disney Productions* v. *United States*, 549 F. 2d 576 (9th Cir. 1976); *Bing Crosby Productions, et al* v. *United States*, 588 F.2d 1293 (9th Cir. 1979).

Similarly, as originally enacted, no credit was allowable for property used predominantly outside the United States. This rule has been retained by ACRS.

Despite this authority, however, prior to 1976 the law pertaining to the availability of the credit for movies was by no means certain. Thus, no court had expressly passed on the issue aside from the Ninth Circuit.[4] Additionally, even if the credit

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[2] The Accelerated Cost Recovery System (ACRS) contained in the recently enacted Economic Recovery Tax Act of 1981 has these same objectives.

[3] As originally enacted, to be eligible for the credit the property had to be depreciable and have a useful life of at least 4 years. Larger credits were allowable for more durable equipment—assets with longer useful lives—with the full credit (8 percent) allowable for property with an expected life of 8 years or more. Over the years the credit provisions were amended so that, prior to ACRS, no credit was allowable for property with an expected life of less than 3 years, a 3⅓-percent credit was allowed if the expected life was between 3 and 5 years, 6⅔ percent if between 5 and 7 years, and a full 10-percent if the expected life was 7 years or more. These rules continue to apply to property not subject to ACRS. For property covered by ACRS, a 6-percent credit is allowable for property assigned to the 3-year class, and a 10-percent credit is allowed for property in the 5- and 10-year classes and the 15-year public utility class. Recapture rules are provided which have the result of allowing a credit of 2 percentage points for each year the property is held.

[4] A lower court decision in Texas had held that the credit was not allowable for the costs of producing tapes and film used to produce pictures containing seismic information. *Texas Instruments, Inc.* v. *United States*, 407 F. Supp. 1326 (N. D. Tax 1976). That decision was subsequently reversed by the Fifth Circuit. *Texas Instruments, Inc.* v. *United States*, 551 F. 2d 599 (5th Cir. 1977).

were allowed, a number of issues remained unresolved such as the type of film (or similar property) eligible for the credit, the useful life of the property (upon which the amount of the credit depended), the costs to be included in the credit base, and the determination of whether there had been predominant foreign use of the film (for which no credit would be allowed). Additionally, perhaps as the result of the uncertainties as to the availability of the credit, movies were increasingly being produced outside the United States.

Accordingly, as part of the Tax Reform Act of 1976 the Congress enacted a comprehensive provision, section 48(k) of the Internal Revenue Code, specifically relating to the investment credit for movie and television films. Section 48(k), designed to provide the exclusive set of rules in this area, was enacted both to resolve open issues for past and future years and to provide an incentive for movie production (and thus the creation of jobs) in the United States.

Accordingly, section 48(k) is a carefully crafted section whose provisions reflect compromises and incentives. For example, section 48(k) generally allows a 6⅔-percent credit for the covered films, which percentage represents a compromise determination with respect to useful life. Similarly, section 48(k) excludes certain participation payments from the credit base. As an incentive measure, section 48(k) exempts films from the foreign use rule and allows the credit for all indirect production costs if 80 percent of direct production costs are allocable to the United States.

Additionally, section 48(k) allows the credit only with respect to motion picture films and video tapes and only if the film (or tape) is a "qualified film." A "qualified film" is defined in section 48(k)(1)(B) as a film (or tape) "created primarily for use as public entertainment or for educational purposes. Such term does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature."

Thus, section 48(k) carefully circumscribes the property eligible for the credit. Only motion picture films and video tapes are eligible and then only certain types of films and tapes. Thus, no credit is allowed under section 48(k) for photography or for threatrical productions. Similarly, no credit is allowed for films whose market is topical or transitory in nature such as news shows, sporting events, interview shows, game shows, or award shows.

H.R. 2295

H.R. 2295 would expand the definition of a qualified film in section 48(k)(1)(B) to include not only educational motion pictures and video tapes, but also educational filmstrips. A filmstrip, unlike a motion picture or video tape, does not show a moving image. Rather, a filmstrip is essentially a series of still pictures which are shown sequentially. Thus, the filmstrip is similar to a series of slides combined on a single reel.

We recognize that arguments may be made that filmstrips are functionally equivalent to credit-eligible films and tapes and that, therefore, they too should be allowed the credit. The Treasury believes, however, that the distinctions carefully crafted by the Congress in section 48(k) must be preserved. We believe that making inroads into the lines drawn by that legislation will inevitably lead to other unwarranted extensions in the future, including those which the Congress has heretofore resisted. Further, inasmusch as we believe that allowing the credit in the first place for the full capitalized costs of producing movies is questionable, we believe that the credit should not be extended to this or to other areas.

While it may be true that filmstrips resemble credit-eligible films, it is also true that they closely resemble slides and, by extension, photographs, for which no credit is allowed. While certainly the production of these items for educational purposes is laudatory, we do not believe that educational policy is reason to extend to them the investment credit under section 48(k). If the credit were allowed for filmstrips, would not other educational materials be equally as deserving? Could a distinction be drawn, for example, between filmstrips and books or records used in the schools? For reasons I will explore more fully later, we do not believe books and records should be eligible for the investment credit.

Further, section 48(k) applies to entertainment as well as to educational films. Accordingly, if educational slides and photographs were allowed the credit, a compelling argument could be made that the credit should also be allowed for the capitalized costs of producing slides and photos used for entertainment (provided their market is not transitory or topical). Indeed, equally compelling arguments could be made for lithograph plates and other works of art. We do not believe that, in enacting section 48(k), Congress intended to allow the investment credit for these items. Further, as I will explain, we do not think it good tax policy to extend the credit to them.

By the same token, if the film-filmstrip distinction were eroded, we believe that the other distinctions made by section 48(k) would also be vulnerable. For example, in the recent past, proposals have been made to extend the credit provisions to theatrical productions and to television game shows. This past summer, in enacting the Economic Recovery Tax Act, the Congress resisted such extension. We believe that continued opposition will become more difficult once the ones originally drawn by section 48(k) are reexamined. Similarly, such reexamination might result in pressure on the transitory-topical limitation generally, thus raising the possibility of extending the credit to interview shows, news shows, and sporting events.

We believe that any expansion of section 48(k) and the principles it embodies, is inappropriate. Indeed, if anything, the law should move in the opposite direction.

Section 48(k) rests on a dubious premise—that all capitalized costs of producing a movie are to be included in the tangible embodiment of that production (the negative)—and therefore should be allowed the credit. We believe that at least some portion of a movie's value is attributable to the intangible elements—the performances that are recorded and the right to exploit those performances through the copyright attached to the work. In enacting the credit in 1962, the Congress expressly denied its application to intangible assets, choosing instead to realize the credit's goals through productive machinery and equipment. Accordingly, we believe that, at least to some extent, section 48(k) is inconsistent with the credit's overall purposes.

By the same token, however, we appreciate the line of cases and the legislative history which indicate that movies and television films are eligible for the credit. We also recognize the various problems presented by that rule and which section 48(k) was designed to resolve. Accordingly, on balance, we believe that section 48(k) is a sensible provision given its purpose and the context in which it was enacted.

We believe strongly, however, that the principles of section 48(k) should be confined to the movie area. Generally, every intangible may be embodied in some physical form through films, tapes, records, plates, or other recording device. The value of these "recorded creations" is generally attributable primarily to the right to distribute or exploit the item through a copyright or patent, or is otherwise merely the embodiment of the intangible performance or show. Accordingly, we believe that the costs of creating and recording the item should not be eligible for the credit since these costs are attributable largely to the noncredit-eligible intangibles elements. Thus, we believe that the credit should not be allowable for the costs of producing such items as records (i.e., the master record), books (computer tapes or plates), lithographs (plates), and computer software.

In this connection, I wish to emphasize that the Treasury is very concerned with the recent trend of taxpayers applying the investment credit to their investment in intangibles. We understand that tax shelter promoters are claiming this credit in various packaged transactions. We also understand that many in the recording industry are claiming the credit for the total capitalized costs of producing the master record. Inasmuch as the courts generally have not been sympathetic to the Treasury's views in this area, we would hope that the Congress, if necessary, would help us resist such an inappropriate and costly extension of the investment credit.

Thus, to summarize, we believe that section 48(k), a carefully drafted provision intended to deal with a specific, limited problem, should be left unchanged. We oppose any attempt to expand its provisions since expansion could have seriously adverse consequences in this very sensitive area.

H.R. 2397—LENDING OR FINANCE COMPANIES

H.R. 2397 would amend the provisions of the Internal Revenue Code relating to the taxation of personal holding companies in two respects. First, it would tighten the eligibility rules for the "lending or finance company" exclusion from the definition of a "personal holding company" by increasing the amount of business expenses needed to qualify for the exclusion. Second, it would liberalize the definition of a "lending or finance business" by including within such definition the business of making loans with maturities of between 60 and 144 months and the business of making loans involving open end credit transactions (revolving credit). The Treasury supports that part of H.R. 2397 which tightens the eligibility rules for a "lending or finance company." Furthermore, the Treasury does not oppose the provisions of H.R. 2397 which would liberalize the definition of a "lending or finance business" by increasing the maturity and types of eligible loans for such a business provided that the business expense eligibility test is tightened at the same time.

Under current law, a corporation is excluded from the definition of a "personal holding company" as a "lending or finance company" if: (1) 60 percent or more of its ordinary gross income is derived directly from the active and regular conduct of a "lending or finance business"; (2) its personal holding company income (computed without regard to income from its lending of finance business and by including the

entire amount of certain other items) during the taxable year is not more than 20 percent of ordinary gross income; (3) the sum of its business expenses that are directly allocable to the regular and active conduct of its "lending or finance business" equals or exceeds the sum of 15 percent of so much of the ordinary gross income therefrom as does not exceed $500,000 plus 5 percent of so much of the ordinary gross income therefrom as exceeds $500,000 but not $1,000,000; and (4) loans outstanding at any time during the taxable year to a person who is a 10 percent shareholder during such taxable year do not exceed $5,000 in principal amount.

H.R. 2397 would remove the $1,000,000 of ordinary gross income cap on the calculation of the amount of business expenses needed to qualify as a "lending or finance company," so that the amount of expenses needed to qualify would be 15 percent of ordinary gross income from the lending or finance business up to $500,000 of such income (as under current law) plus 5 percent of the excess of such ordinary gross income. The Treasury supports this part of H.R. 2397. It insures that business qualifying for the exception continue as "active" businesses.

H.R. 2397 would also liberalize the personal holding company provisions relating to the types of loans that are included in the definition of a "lending or finance business." Under current law, the term "lending or finance business" does not include the business of making loans or purchasing or discounting accounts receivable, notes, or other installment obligations, if (at the time of the loan, purchase or discount) the remaining maturity exceeds 60 months, unless the loans, notes, or installment obligations are secured by conditional sale contracts, chattel mortgages or chattel lease agreements arising out of the sale of goods or services in the course of the borrower's or transferor's trade or business. Income from loans not included within the definition of a "lending or finance business" cannot be counted toward the 60 percent gross income test for qualification as a "lending or finance company." H.R. 2397 would liberalize the definition of a "lending or finance business" by increasing the maturity of loans which can be included in such a business to 144 months from the current 60 months. In addition, the business of making loans under lines of revolving credit would not be included in the definition of a "lending or finance business."

The Treasury does not oppose this provision of H.R. 2397. Extending the maturities on loans that can be made by a "lending or finance" business to 144 months reflects the changes in the maturities of loans generally which consumer finance companies are now making.

Although state laws may continue to restrict the maturities and interest rates for these companies, the statute must contain some limitation to prevent small, closely held consumer finance companies from becoming mere passive investment vehicles. Increasing the maturities of loans that can be made as a part of a "lending or finance business" places greater emphasis on the revised business expense test and the requirement that the conduct of the "lending or finance business" be "active and regular," a necessary subjective judgment, in limiting the creation of mere incorporated pocketbooks.

Similarly, Treasury does not oppose allowing such closely held consumer finance companies to offer revolving credit agreements as part of their "lending or finance business." In many cases, widely held consumer finance business." In many cases, widely held consumer finance companies are able to offer such loan agreements. So long as these businesses remain engaged in the active and regular conduct of a "lending or finance business," it seems inappropriate to restrict the types of loans which they are able to make in pursuit of this business.

H.R. 2860—ACCRUAL OF STATE TAXES

H.R. 2860 would amend section 461 of the Code (generally dealing with the time of a deduction) to allow taxpayers using the accrual method of accounting to deduct state taxes in the proper year of accrual even though the date of accrual of the tax has been accelerated by state law. Although the amendment is intended primarily to benefit taxpayers subject to the California corporation franchise tax, it would also apply to all taxpayers with respect to taxes imposed in all jurisdictions. The Treasury supports H.R. 2860.

Under current law (section 461(d)), if a state accelerates the accrual date of a tax, taxpayers using the accrual method of accounting must continue to accrue and deduct such tax at the same time as before. This constraint was enacted in 1960 to stop situations where states were changing the assessment or lien dates of their property taxes and consequently allowing taxpayers within their jurisdiction to claim an earlier deduction in computing their Federal income tax. Such action also resulted in taxpayers being allowed a double deduction in the year of the change in state law. For example, if the state changed the lien date of 1958 property taxes

from January 1, 1958 to December 31, 1957, taxpayers were entitled to deduct in 1957 the tax that accrued on January 1, 1957 (for 1957) and on December 31, 1957 (for 1958), Section 461(d) was enacted to plug this "tax gimmick." Subsequent to the 1960 amendment, if a state changd its lien date from January 1, 1962 to December 31, 1961, taxpayers would continue to accrue the tax on January 1, 1962. Section 461(d) applies to all taxes and without regard to the reason for acceleration.

California Franchise Tax.—In 1971, California amended its corporation franchise tax law effective in 1972. Both before and after the amendment the tax for a particular year (the "tax year") was (and is) based on the income of the preceding year (the "income year").[5] Under the law in effect before 1972, the tax for the year in which a corporation dissolved was based only on the income of the year preceding the year of dissolution. Thus, tax was never paid on the income of the year of dissolution. In Rev. Rul. 68-305, 1968-1 C.B. 213, the IRS ruled that under the pre-1972 California law, the tax did not accrue until the "tax year" since all events that determined the fact of the liability did not happen until the taxpayer actually did business in the state in such "tax year."

Since 1972, the tax for the year in which a corporation dissolves is based on the income of the preceding year plus the income of the year of dissolution. Therefore, since a corporation will now always pay tax on the income of a year in which it engages in business, even if it dissolves in that year, the fact of the liability of the tax occurs in that year. In Rev. Rul. 79-410, 1979-2 C.B. 213, the IRS held that under the law in effect since 1972, the tax properly accrues in the "income year". But, the IRS also held that the 1972 change in California law resulted in an acceleration of the accrual of the franchise tax from the "tax year" to the "income year," and therefore under section 461(d), corporations must continue to deduct the tax only in the "tax year." this was affirmed by the Tax Court in Epoch *Food Service, Inc.*, 72 T.C. 1051 (1979).

The section 461(d) constraint applies to all taxpayers—those that were in existence at the time of the change in state law as well as those that came into existence after the change in state law, even though, with respect to these latter taxpayers, there was no double deduction in any one year. (See section 1.461-1(d)(1) of the regulations.) However, the District Directors in California allowed corporations that were incorporated after the 1972 change in California law to accrue the California franchise tax in the earlier "income year." In Rev. Rul. 79-410 the National Office of the IRS ruled that this position of the District Directors is contrary to section 461(d) and the regulations. Absent legislation, all corporations incorporated after 1971 that have been deducting the tax in the "income year" will be required to change the time of deducting the tax to deducting it in the later "tax year."

The purpose of section 461(d) is to prevent the revenue loss that results when two years of a particular tax are deducted in one year. Absent overriding considerations, we believe that deductions should be allowed to a taxpayer using the accrual method of accounting in the year in which the deduction properly accrues under tax accounting principles. Since the enactment of section 461(d) in 1960, a method has been devised which allows a proper accrual in the earlier year, but without the revenue loss that would result from a double deduction in one year. That method is the use of a "suspense" account. A "suspense" account, in effect, generally defers what would have been the most recent deduction before the change in method of accounting until a later period, usually when the taxpayer ceases to engage in the subject trade or business. The use of suspense accounts has made it possible to amend the Code to allow acceleration of deductions (or reductions of gross income) for vacation pay (section 463), discount coupons (section 466), and paperback and record returns (section 458). In the case of deductions for state taxes that would be deferred under section 461(d), the use of a suspense account would allow taxpayers the benefits of the deductions in the normal year of accrual, (even after a change in the law by the taxing jurisdiction), without the Treasury incurring the revenue loss that would otherwise result from there being two deductions in one year. Although one of the two deductions is deferred, the taxpayer obtains the benefit of the incremental increase in the tax paid being deductible in the earlier year. We do not believe it is necessary for section 461(d) to continue to apply if a suspense account is used to mitigate the revenue loss.

H.R. 2860 would amend section 461 and provide taxpayers an election to have section 461(d) not apply if the taxpayer agreed to the use of a suspense account for the otherwise double deduction. Therefore, H.R. 2860 would allow all taxes to be accrued at the proper time of accrual, if a state has accelerated the accrual date. Thus, if a taxpayer were in 1982 to elect the provisions proposed by this bill, the

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[5] Since 1966 the tax has been paid on an estimated basis in the preceding year.

franchise tax for 1983, based on 1982 income, could be deducted in 1982 instead of 1983, and the tax based on 1981 income would be placed in a suspense account.

The "suspense" account mechanism that would be provided is similar to the suspense account currently used in other areas (such as discount coupons). The provision would apply to all state taxes and, with one exception, would be applicable for taxable years ending after date of enactment. The amendment would be made retroactive for taxpayers who in the past first become subject to the state tax after the change in state law and have consistently (although improperly) accrued the tax in the earlier year. This would ease what would otherwise be an administratively burdensome situation and is appropriate since there has not been a double deduction in any year.

The Treasury supports H.R. 2860.

H.R. 3581—FOREIGN COMMODITY INCOME

H.R. 3581 would amend section 954 of the Internal Revenue Code (relating to the definition of foreign base company income for purposes of the controlled foreign corporation (CFC) provisions of the Code) to exclude certain dividends from the definition of "foreign personal holding company income." Dividends paid by a CFC from its earnings and profits would be excluded provided at least 80 percent of the gross income of the CFC was derived from the purchase or sale of agricultural commodities not grown in the United States in commercially marketable quantities. For this purpose, gross income would not include subpart F income of the CFC as defined in section 952(a) of the Code. The Treasury Department opposes H.R. 3581.

The foreign personal holding company income of a CFC must generally be included in the gross income of the U.S. shareholders of the CFC, even if such amounts are not actually distributed to those shareholders. The CFC provisions of the Code were enacted to eliminate tax deferral generally with respect to certain income of U.S.-controlled foreign corporations where such income was derived from transactions with related persons and did not otherwise originate in the foreign country of incorporation. Thus, dividends received by a CFC from its foreign subsidiaries are treated as foreign personal holding company income, with certain very limited exceptions. H.R. 3581 would expand the exceptions to such treatment solely to address a current problem one corporation has in connection with its activities in a certain country. The amendment is directly contrary to Congress' purpose in enacting the CFC provisions of the Code.

In addition, H.R. 3581 would be retroactive to taxable years of foreign corporations beginning on or after January 1, 1980, and to taxable years of U.S. shareholders within which or with which such taxable years of the foreign corporations end. In general, we are opposed to retroactive effective dates for tax legislation. In this case, we do not believe there is any reason to depart from this view.

H.R. 4408—REFUND ON EXCISE TAX ON BUSES

H.R. 4408 would provide a new procedure for claiming a refund for the excise tax on buses which was repealed by the Energy Tax Act of 1978, for buses which were sold after April 20, 1977 (the effective date of the repeal) and prior to enactment.

The refund procedures in the 1978 Act required a manufacturer to reimburse the purchaser for the tax before September 5, 1979 in order to be entitled to claim a refund. The application for the refund also had to be filed prior to September 5, 1979. Manufacturers were required to reimburse purchasers prior to receipt of a refund from the Internal Revenue Service to ensure that the refunds actually were paid to the purchaser.

We understand that H.R. 4408 was introduced to provide relief to the customers of a certain bus manufacturer in Pennsylvania which was unable to afford to reimburse large amounts of tax prior to receiving the refund. H.R. 4408 would amend the procedure to permit a claim for refund if the manufacturer makes reimbursement to the purchaser simultaneously with the receipt of a refund. This new procedure will be available until the end of 1982, although the original time provided for refund claims has expired. In addition, any refund would be paid with interest.

The Treasury Department does not object to the provisions in H.R. 4408 which permit a refund despite the failure to comply with the procedures set forth in the 1978 Act, provided the provision for the payment of interest is deleted. In light of the special relief provided by this legislation, the payment of interest as well is inappropriate. In addition, we suggest that the taxpayer's arrangement for reimbursement be subject to prior IRS approval.

Chairman STARK. Thank you very much.

As I indicated to you before the hearings, I have had a chance to review testimony we will hear on this case. It seems to me we are going to spend, the Congress, the Internal Revenue Service, just a couple of dollars debating this refund. I think we will all agree in some form or the other it would be just.

I am sure the person attempting to get the refund has spent a few dollars in legal fees to get here.

There is some indication in the testimony of the witnesses we will hear later that some of this could have been avoided if our Internal Revenue Service branch office in the case had either responded in a more timely fashion or been more cooperative.

I just wanted to suggest that we constantly think about how we can serve our clients, the taxpayers, and prevent some of these things from happening.

I hope it was an isolated case, but I think it is always a good idea to review what we are doing and hope that the budget cuts aren't going to cut too deeply into our ability to staff your regional offices with the result of being pennywise and pound foolish.

Mr. CHAPOTON. I take that advice seriously, Mr. Chairman. I think that is a good point.

The legislation, of course, contemplated very specifically the procedure, that is, that the refund would be made prior to the purchaser—prior to the refund being received by the manufacturer.

As you point out, there were circumstances here which made it impossible for this taxpayer to meet that procedure, but in spite of the difficulty of having the IRS act rapidly sometimes, it is—those situations occur. It is difficult to say that conclusively it could have been worked out at that time.

I do feel that interest on retroactive legislation is undesirable.

Chairman STARK. I agree with you there.

One other question. This deals again with the home business deductions.

I was approached recently by some friends, a husband and wife who are both architects.

I would assume they are at least in the 50-percent marginal bracket. They were selling china dishes. They wanted to know if I wanted to buy dishes. It turns out what they were attempting to do is operate this extra business of selling china in their home to get a deduction and be able to depreciate part of their home where they would display the china. I don't think they really cared if they sold any china or not. It seems to me that there ought to be—if there isn't—some kind of threshold for a part-time business that qualifies a home.

We ought to think—the Service ought to think of some ways we can define this in legislation or——

Mr. CHAPOTON. Under the regulations as now issued, the taxpayer may have only one principal place of business. Thus, where the taxpayer has an office downtown, that would preclude an office in his home.

Under the change we are talking about, if the taxpayer had a secondary business, which would be the case you described, he could take deductions for the use of part of the home as the principal place of the secondary business but the use still must meet the test—and this is important—that the room so used be

used exclusively for that purpose, for no other purpose, and be used on a regular basis.

In addition, the deductions could not exceed the income from that secondary business. So I think there are appropriate safeguards.

I think those safeguards are important. Otherwise we get into the problem this legislation was designed to deal with. That is, you never know whether it is a business, a hobby, and you never know whether the allocation of expenses is correct.

Chairman STARK. Thank you.

Mr. Duncan?

Mr. DUNCAN. Thank you, Mr. Chairman.

I am glad to see that Treasury is in general agreement with H.R. 4071, but could you please review the points of the bill that you think should be clarified?

Mr. CHAPOTON. Mr. Duncan, on page 11 of my testimony I speak to that.

I would point out the term "shared equity financing arrangement" which in the legislation would be somewhat vague in its requirement that two or more persons acquire interest in the property.

We agree that undivided interest should qualify, but as for other types of interest, we think the type of interest we are talking about should be spelled out and it should be decided independently whether a particular type of ownership interest is appropriate or is not appropriate.

That is one.

We also think the provision should make it clear that only the nonresident coowner receives relief from section 280A. The resident coowner should remain fully subject to section 280A, for example if he sublets the unit for part of the year, he should meet the tests already in section 280A.

Mr. DUNCAN. Thank you, Mr. Chairman.

Chairman STARK. Mr. Heftel?

Mr. HEFTEL. Thank you, Mr. Chairman.

I can only comment insofar as the dual use of a residence is concerned that you are endeavoring, I think, to be quite fair and understanding in the way we approach the problem.

I think you still are going to have the question of when is it being exploited and when it is legitimate. I hope with the Chairman that you have enough personnel to make those judgments.

Mr. CHAPOTON. I agree with you, Mr. Heftel. I personally have been surprised at the response to the assumed or presumed harshness of section 280A, but the responses have made good points.

We are attempting to respond in an equitable manner to the comments.

Mr. HEFTEL. Thank you.

Regarding 2295, and the whole question of when to extend the investment tax credit, and how do you draw the line, how do you make distinctions, I think we are both aware that the process for the film, the movie, or the so-called film strip, the whole process is the same.

It is a very difficult distinction.

On page 14 of your testimony I think you touch on the issue. I wonder if we can clarify? I will read quickly from that page the appropriate sentence:

> For example, section 48(k) generally allows a six and two-thirds percent credit for the covered films, which percentage represents a compromise determination with respect to useful life.

I have wondered if the intent of the legislation either was or should have been the ability to demonstrate to the IRS both the useful life and a resale value, that any other approach from whatever reading I have done appears to be somewhat arbitrary and certainly susceptible to challenge.

I wonder if you would comment on the content of useful life?

Chairman STARK. I would be constrained to suggest that that question is not in order. It is not before us; if you want to discuss in general whether the useful life of any asset and its resale value was part of the investment tax credit, but I am not sure that that is before the committee this morning.

I don't know whether the Secretary wants to be on record in defining what kind of assets qualify and what don't.

Mr. HEFTEL. If we are talking about when and how we allow a two-third investment tax credit for the so-called educational and entertainment film industry, it seems you can't do that and the Treasury could not themselves do it without discussing useful life and I think should be added also resale value.

Chairman STARK. I guess what I am suggesting is that your question implies that useful life or resale value ever figured into what assets qualified for the investment tax credit—I think there is a step way before that.

For example, we have never allowed investment tax credit for elephants that are kept as pets, although they may have a long useful life and a resale value.

I think the issue is, do we allow investment tax credit for an elephant kept as a pet regardless——

Mr. HEFTEL. But you can't turn the elephant into a motion picture. There is a slight distinction.

Chairman STARK. You can turn a turkey into a motion picture, however.

Mr. HEFTEL. That is quite true. You may have had more experience than I with turkeys.

I am happy to let the Treasury comment and find out what they think about the concepts of both useful life and resale value and where they should enter in, if at all.

Mr. CHAPOTON. I know this question, Mr. Heftel, has been presented. Section 48(k) does contain an election under which taxpayers may elect to claim the credit based on useful life. I understand their election is used very seldom, since it requires application to all of the films of the producer.

Beyond that I believe I would prefer not to go on record as dealing with the question.

We have before us now a singular question in the regulations under ACRS that we are going to have to deal with. I would prefer to stay away from it until we do deal with it in that context.

Mr. HEFTEL. Thank you, Mr. Chairman.

Chairman STARK. Mr. Schulze?

Mr. SCHULZE. I have no questions.

Chairman STARK. Mr. Moore?

Mr. MOORE. No questions, Mr. Chairman. Thank you.

Chairman STARK. Thank you very much, Mr. Secretary. We appreciate your cooperation and your patience with us this morning.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Chairman STARK. We will now call a panel of Mr. Bell, Citizen's Choice; Boyce Magli, vice chairman, National Association of Realtors, Legislative Subcommittee on Federal Taxation; Mr. Stephen B. Purvis from Virginia Beach; Mr. Jack Luria of the Artery Organization.

We are going to ask Mr. Luria to postpone his testimony until the conclusion of the hearing, at which time we will hear him in light of the lack of timeliness in submitting his statement.

STATEMENT OF THOMAS D. BELL, JR., EXECUTIVE VICE PRESIDENT, CITIZEN'S CHOICE

Mr. BELL. Thank you, Mr. Chairman. It is good to be before the committee today to discuss the so-called family rental home office tax issue.

My name is Tom Bell, executive vice president of Citizen's Choice, a national grassroots taxpayers organization founded in 1977.

I represent 74,000 members nationwide. We believe Citizen's Choice represents a true cross-section of America in that our 74,000 members range from Fortune 100 CEO's to bus drivers.

We really have no special interest but good government. Therefore, we are particularly appreciative of this opportunity to testify on this issue because it has such a great impact on our membership.

In a recent membership study we discovered that a majority of Citizen's Choice members who are largely entrepreneurial in their business pursuits have one or more businesses. Many of them have rental property and most all of them have relatives of one sort or the other to whom they might legitimately rent property.

Our members are generally activists and because of their activism, they are extremely interested in this particular piece of legislation.

As originally proposed, the rules under section 280 of the code would have unfairly penalized producing Americans in general and a vast majority of our membership specifically.

Citizen's Choice National Commission on Taxes and the Internal Revenue Service conducted an 18-month study that was just recently completed.

As part of a study we held field hearings in 10 cities around the country and collected over 6,000 pieces of testimony.

What we discovered from our commission's findings was that the relationship between taxpayers and IRS is declining rapidly and has reached the dangerous point.

Because of this decline of trust between citizen and Government, the taxpayer has begun to feel that the system is so complicated and so grossly unfair that the avoidance of tax is socially acceptable.

We heard normally God-fearing and law-abiding citizens say that they thought the Government was taking advantage of them and, therefore, it was OK for them to attempt to take advantage of the Government.

This is a new phenomena in our opinion, at least a growing phenomena; and this particular legislation is just another example or another hook on which the taxpayer can hang his hat and say that once again Internal Revenue Service is taking a good intent on the part of Congress and interpreting it in such a way that assumes the taxpayer will avoid taxes if possible, and to increase the revenue benefits at the loss to the taxpayer.

Therefore, we ask the committee to consider principally three points: First, who is it that makes tax policy? The Internal Revenue Service or the Congress? The Congress represents the citizen, the taxpayer, and works hopefully and usually in his best interests.

The Internal Revenue Service, on the other hand, and Treasury, have a completely different responsibility which we understand. That is, to maximize revenue.

So it seems to Citizen's Choice that it is awfully important that the Congress and not the IRS interpret what their intention was when they make tax policy.

Second, at a time when everyone is talking about productivity and the revitalization of the American economic system, why penalize those people who are investors in real property in terms of rental property or who are the producers in terms of those that have second jobs which they might conduct from their home?

Last, once again, based on our national commission's findings, it seems the Internal Revenue Service's reaction to the proposed rules under section 280, at least those as we understood them before Mr. Chapoton's remarks, would assume once again that the taxpayer will, if given any kind of opportunity, avoid taxes.

Therefore, we urge the committee to move forward on reporting legislation which would provide for the elimination of unfair regulations proposed by the IRS under section 280 regarding legitimate family rental and home business use.

Thank you.

[The prepared statement follows:]

STATEMENT OF THOMAS D. BELL, JR., EXECUTIVE VICE PRESITENT, CITIZEN'S CHOICE

SUMMARY

Citizen's Choice is a national grassroots taxpayers' organization founded in 1977. It has 75,000 members nationwide.

Citizen's Choice supports the intent of proposals such as H.R. 588, 890, 1177, 1280, 1410, and 4071, which would repeal the so-called family rental/home business tax. It addresses two problems which affect Citizen's Choice members, many of whom are independent contractors: namely, the business use of homes and the rental of residences to family members.

Citizen's Choice believes that home-based entrepreneurs who operate part-time businesses should be allowed to deduct business expenses for maintaining offices in their homes. The imposition of proposed IRS regulations under section 280A of the Internal Revenue Code would only serve to discourage such entrepreneurship and penalize citizens for having more than one business.

The organization also disagrees with the proposed ruling by the Internal Revenue Service which would cause individuals who rent homes to family members to pay higher taxes than if they rent to nonfamily members. Although the IRS argues that

the 1976 Tax Reform Act empowered them to issue the regulations, Citizen's Choice disagrees.

Citizen's Choice supports this clarifying legislation because it would remove any hint in the United States Tax Code that renting to family members automatically carries a higher tax bill.

Citizen's Choice feels that these proposed regulations under section 280A presuppose that the American taxpayer is attemping to take advantage of the tax system and therefore pay less than a fair share of taxes. The organization calls the committee's attention to the fact that the American people have maintained a superior record of voluntary contributions to the U.S. Treasury and that citizen confidence in the system must not be eroded.

Mr. Chairman, I am Thomas D. Bell, Jr., Executive Vice President of Citizen's Choice, a national grass roots taxpayers' organization founded in 1977. Citizen's Choice has 75,000 members nationwide.

I am pleased to have this opportunity to appear before the Subcommittee on Select Revenue Measures to comment on these proposals which would repeal the so-called family rental/home business tax. Citizen's Choice is interested in section 280A because it concerns two specific problems which affect our members, many of whom are independent contractors: namely, the business use of homes and the rental of residences to family members.

The family rental/home business tax stems from provisions included in the 1976 Tax Reform Act and the subsequent interpretation of those provisions by proposed IRS rules under section 280A of the Internal Revenue Code. These proposed regulations were published in the Federal Register on August 7, 1980 at page 52399.

Citizen's Choice is particularly concerned with the regulations which set forth rules for determining the deductibility of expenses in connection with the business use of a dwelling unit used by the taxpayer for personal purposes during the year.

The proposed regulations require that a home office be not only the principal place of the taxpayer's business, but the principal place of the taxpayer's "overall business activities" before a deduction is allowed. Under the proposed IRS regulations, a homeowner who operates a legitimate part-time or secondary business from his or her home will no longer be able to deduct business-related expenses for that office.

Citizen's Choice believes that home-based entrepreneurs who operate part-time businesses should be allowed to deduct business expenses for maintaining offices in their homes. The imposition of these proposed regulations would only serve to discourage such entrepreneurship. Why should the government penalize citizens for having more than one business?

Those who argue in favor of the proposed IRS regulations contend that the 1976 Tax Reform Act empowered the IRS to issue the regulations. Citizen's Choice disagrees. We believe that the proposed regulations place more severe limits on the deduction of expenses resulting from the business use of a home than was ever intended by Congress.

When Congress adopted section 280A(c)(1)(A) in 1976, it was concerned with the lack of specific rules governing the deductions of expenses for maintaining an office in the taxpayer's home. Both the House and Senate Committee reports on the Tax Reform Act of 1976 indicate that Congress wanted to replace the subjective standard developed by several courts which permitted deductions where a home office was "appropriate and helpful" to the taxpayer's business. In addition, both reports indicate that the committees feared that "expenses otherwise considered nondeductible personal, living, and family expenses might be converted into deductible business expense simply because, under the facts of a particular case, it was appropriate and helpful to perform some portion of the taxpayer's business in his personal residence."

The explanation of the provisions contained in the House and Senate Committee reports also stress that the provision was intended to prevent the deductions of personal and family expenses. They discuss the fact that under section 280A, the home office must be used exclusively for the business, that it must be used on a regular basis, and that it must be used in a trade or business, not merely for income producing activities.

The explanations neither discuss nor provide examples of how a taxpayer with two or more businesses is to be treated.

Citizen's Choice believes that the use of a home office to conduct a second or third business is no more likely to result in the taxpayer deducting personal or family expenses than the use of a home office to conduct a single business. Nor does Citizens' Choice believe that adoption of the IRS position in the final regulations would help produce the objective standards Congress sought, but instead would result in requiring an additional subjective decision. A taxpayer with several busi-

nesses, some of which are run from a home office and others from a second location, would be forced to prove annually that the home constituted the principal business location of the overall business activities. And if the taxpayer's income from the various businesses fluctuated annually, the principal site of the overall business activities, and thus the right to deduct the home office expenses, might vary from year to year.

Citizen's Choice is deeply concerned with this interpretation. As I have noted, many of our members are independent contractors. They are entrepreneurs who set their own goals, hours and methods of operation and their own hard work. Independent contracting is an important part of the economy. It offers jobs to people who choose not to accept full-time employment and it offers other individuals a supplementary income. In addition, it offers economic independence to those citizens who are willing to work hard.

We oppose the proposed IRS regulations under 280A of the Internal Revenue Code because they are an attempt by government to jeopardize our economic freedom.

Citizen's Choice does not believe this was the intent of Congress in the Tax Reform Act of 1976. We feel it is unfortunate that the IRS has chose to interpret the "principal place of business" test to mean that if you hold a full time job and run another business from your home, you lose some of your business deductions for the second business.

Citizen's Choice supports the amendment of section 280A. Enactment of this legislation would make it clear that a deduction would be available without unwarranted limitations for expenses related to the use of a portion of a home for the operation of a business.

The bill also provides that the principal place of business test is met for any business as long as that business is primarily run from the home.

Mr. Chairman, I also wish to comment briefly on the matter of family home rentals. Citizen's Choice members have been concerned with the proposed ruling by the Internal Revenue Service which would cause individuals who rent homes to family members to pay higher taxes than if they rent to non-family members.

Once again, this tax stems from provisions included in the 1976 Tax Reform Act, and as those provisions were subsequently interpreted by proposed IRS rules. As in the case of the business use of homes, the IRS argues that the 1976 Tax Reform Act empowered them to issue the regulations. Once again, Citizen's Choice disagrees.

In 1976, Congress intended to put a limitation on the availability of business deductions relating to vacation homes which taxpayers used themselves for substantial periods. "Personal use" was broadly defined to include use by a sister, brother, spouse, grandparent, child, or grandchild. The rule has been interpreted by the Internal Revenue Service to apply to any dwelling unit, including houses, apartments, condominiums, mobile homes and boats, as well as to vacation homes. This presents a problem to an individual who rents any residence to a family member.

Citizen's Choice supports amendment of section 280A in order to remove any hint in the U.S. Tax Code that renting to family members automatically carries a higher tax bill. It would remove language from the section of the Internal Revenue Code which could be interpreted by the IRS to allow discrimination against renting to family members. If a dwelling is rented at market rates, a taxpayer would receive the same treatment regardless of his or her relationship with the tenant.

Mr. Chairman, Citizen's Choice believes one of the fundamental questions in the consideration of this issue is the basic right of the individual in our society. The interpretations of the Tax Reform Act of 1976 by the IRS which I have outlined cause one to wonder just who is in charge: Congress or the IRS?

This IRS interpretation presupposes the American taxpayer is guilty of purposeful avoidance of paying legitimate taxes. Citizen's Choice urges the Committee to consider that the American people have maintained a superior record of voluntary contributions to the United States Treasury. It is clear to us, however, that taxpayer frustrations with inconsistencies in existing law and questionable IRS practices threaten to undermine the willingness of citizens to comply with IRS regulations. These new quirks in IRS rules have already caused public outrage and can only serve to exacerbate citizen frustration with the system.

Mr. Chairman, confidence must be restored in the federal tax-collecting system. These proposals have been offered to clarify congressional intent. They are not designed to force limitations on IRS rulemaking authority.

Citizen's Choice supports the early enactment of legislation which would amend section 280A.

Chairman. STARK. Thank you, Mr. Bell. I appreciate your having to operate under the constraints of that light blinking in your face.

I am sure the other members of the committee appreciate your brevity.

We have had a chance to look at your testimony. We do appreciate that.

STATEMENT OF BOYCE MAGLI, VICE CHAIRMAN, SUBCOMMITTEE ON FEDERAL TAXATION, NATIONAL ASSOCIATION OF REALTORS

Mr. MAGLI. I am Boyce Magli, a realtor from Franklin, Tenn., and vice chairman of the National Association of Realtors Legislative Subcommittee on Federal Taxation.

We appreciate the opportunity to express our strong support for bills that address the problems created by section 280A of the Internal Revenue Code and particularly H.R. 1290, introduced by Representative Bafalis.

This bill would repeal the "family rental tax" and provide clarification with respect to deductions for home offices.

One of the situations addressed by the Congress in 1976 was the attempt by some taxpayers to claim business deductions for vacation homes which the taxpayers used personally for a substantial period of time during the year.

Naturally a business deduction for maintenance and other expenses should be available only when the property is held in substantial part for business purposes.

The legislation enacted by Congress placed limitations on these deductions when the taxpayer or a family member personally used the property.

The IRS has interpreted this provision so that it is a personal use of a property by the taxpayer even if the relative is being charged a fair rental value.

It would still be considered a personal use even if the taxpayer never sets foot on the property during the year. This is going too far.

Such an interpretation is discriminatory and is beyond the intent of Congress when it enacted this provision.

Certainly we can find no statement in the Congressional Record, the committee reports on the 1976 act, or anywhere else to justify the IRS view.

So long as a fair rental is paid, the tax law should not provide different rules solely because in one case the property is rented to a stranger and in another case the renter is a family member.

H.R. 1290 would amend existing law by making clear that it would not be a personal use of a residence by the taxpayer if the residence was rented to a relative at a fair rental. This change would in no way affect the legitimate concerns addressed by the Congress in 1976 while at the same time preventing IRS from imposing a rule that would unreasonably discriminate against a taxpayer's family.

Another area considered in the 1976 act concerned limitations on the deductibility of expenses associated with home office expenses. The thrust of these limitations was that deductions would not be allowed for casual use of the home as an office and one of the specific limitations was that deductions would be available only if the office was a principal place of business of the taxpayer.

The IRS, in its proposed regulations, provided a further limitation by asserting that a deduction would be allowed only if the home office, in addition to being a principal place of business, related to the taxpayer's principal business.

Thus, if a taxpayer has the industry to operate a business out of the home in addition to his or her primary income-producing activity, the IRS would disallow a home office deduction even though the office is the principal place of business for the second business.

We support H.R. 1290 on this issue because it would make clear that the deduction for home office expenses is available where the home office is the principal place of business for a particular business conducted by the taxpayer. It is incorrect to assume, as does the proposed regulation, that a taxpayer can have only one principal place of business.

H.R. 1290 provides a simple solution to a burgeoning problem created by IRS and, in essence, merely reaffirms the position that many believed Congress had espoused in 1976.

We appreciate Treasury's earlier statement expressing support for this change.

One of the most pressing reasons for enactment of H.R. 1290 is that the proposed regulations are retroactive to 1976.

Taxpayers were generally aware of the new limitations enacted in 1976 and filed their income tax returns mindful of these limitations.

However, they were not, of course, aware at that time or in subsequent years of the interpretation that the IRS would place on these limitations in 1980.

As a result, income tax returns filed in those years will necessarily be found to be at variance with the IRS interpretation unless this Congress acts to clarify existing law and makes these clarifications retroactive to 1976.

Enactment of H.R. 1290 would correct obvious inequities and we urge the committee to support this bill.

I thank the committee for the opportunity to present our views on this bill, which is an important matter for many taxpayers.

I will be happy to answer any questions the committee may have.

[The prepared statement follows:]

STATEMENT OF BOYCE MAGLI, REALTOR AND VICE CHAIRMAN OF THE NATIONAL ASSOCIATION OF REALTORS LEGISLATIVE SUBCOMMITTEE ON FEDERAL TAXATION

My name is Boyce Magli. I am a Realtor from Franklin, Tennessee and Vice Chairman of the National Association of Realtors Legislative Subcommittee on Federal Taxation. This Association, with nearly 700,000 members, is the largest trade association in the United States. Our membership is involved in all facets of the real estate industry—residential, commercial, industrial and farm real estate.

We appreciate the opportunity to express our strong support for bills that address the problems created by section 280A of the Internal Revenue Code and the regulations interpreting that section. We particularly support H.R. 1290, introduced by Rep. Bafalis (R-Fla.) and cosponsored by more than 40 other Members of the House. This bill would provide much needed clarity with respect to the deductibility of expenses attributable to home offices and would repeal the discriminatory anti-family provision that has come to be called the "family rental tax."

ENACTMENT OF THIS BILL IS URGENTLY NEEDED

The Tax Reform Act of 1976 contained a number of provisions designed to prevent taxpayers from deducting as business expenses a number of costs that were in reality personal expenses. Among these provisions were limitations with respect to

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the personal use of a rental property by the taxpayer, offices in the home, and the use of vacation homes. These limitations are not contained in section 280A of the Internal Revenue Code. On August 7, 1980, the Internal Revenue Service issued proposed regulations that set forth a number of additional limitations that appear to be considerably beyond the intent of Congress when it enacted these provisions. Further, I.R.S. proposed to make these regulations retroactive to 1976.

Taxpayers were generally aware of the new limitations enacted in 1976 and filed their income tax returns mindful of these limitations. However, they were not of course aware at that time or in subsequent years of the interpretation that the I.R.S. would place on these limitations in 1980. As a result, income tax returns filed in those years will necessarily be found to be at variance with the I.R.S. interpretation unless this Congress acts to clarify existing law and makes these clarifications retroactive to 1976. It is vitally necessary to prevent I.R.S. from imposing their erroneous interpretation not only in the future but with respect to returns filed in years between 1976 and the present time by taxpayers who were in good faith attempting to comply with the law as passed by Congress.

Unless H.R. 1290 is enacted quickly, these erroneous I.R.S. positions will also have a serious effect on individuals preparing their income tax returns for 1981. Unlike prior years, the widespread notoriety of the I.R.S. proposed regulations has put all taxpayers on notice as to the I.R.S. position and accounting firms and tax preparation services are now forced to counsel taxpayers that deductions they have taken in past years are not now available. Taxpayers must choose between the I.R.S. view and their own reading of the law and, no matter the choice, serious disruptions in the tax administration process will occur. Either amended returns would have to be filed when H.R. 1290 is eventually enacted, or taxpayers could expect to have their returns audited if they ignored the I.R.S. interpretation. H.R. 1290 deserves the immediate attention of this Congress not only to clarify Congressional intent, but to spare taxpayers from having to make this choice.

RENTING TO FAMILY MEMBERS

One of the situations addressed by the Congress in 1976 was the attempt by some taxpayers to claim business deductions for vacation homes which the taxpayers used personally for a substantial period of time during the year. Naturally, a business deduction for maintenance and other expenses should be available only when the property is held in substantial part for business purposes. The legislation enacted by Congress placed limitations on these deductions when the taxpayer personally used the property. The statute defined personal use to include use by a taxpayer's spouse, child, parents, brother, sister or grandparents.

The I.R.S. has interpreted this provision so that it is a "personal use" of a property by the taxpayer even if the relative is being charged a fair rental. It would still be considered a "personal use" even if the taxpayer never sets foot on the property during the year. This is going too far. Such an interpretation is discriminatory and is beyond the intent of Congress when it enacted this provision. Certainly, we can find no statement in the Congressional Record, the Committee Reports on the 1976 Act, or anywhere else to justify this I.R.S. view.

This unwarranted discrimination against family rentals should not be tolerated. So long as a fair rental is paid, the tax law should not provide different rules solely because in one case the property is rented to a stranger and in another case the renter is a family member.

H.R. 1290 would amend existing law by making clear that it would not be a personal use of a residence by the taxpayer if the residence was rented to a relative at a fair rental. This change would in no way affect the legitimate concerns addressed by the Congress in 1976 while at the same time preventing I.R.S. from imposing a rule that would unreasonably discriminate against a taxpayer's family.

BUSINESS USE OF THE HOME

Another area considered in the 1976 Tax Reform Act concerned limitations on the deductibility of expenses associated with home office expenses. The thrust of these limitations was that deductions would not be allowed for casual use of the home as an office and one of the specific limitations was that deductions would be available only if the office was a principal place of business of the taxpayer.

The I.R.S., in its proposed regulations, provided a further limitation by asserting that a deduction would be allowed only if the home office, in addition to being a principal place of business, related to the taxpayer's principal business. Thus, if a taxpayer has the industry to operate a business out of the home in addition to his or her primary income-producing activity, the I.R.S. would disallow a home office

deduction even though the office is the principal place of business for the second business.

It is important to note that the I.R.S. is already litigating this issue and lost a case in the U.S. Tax Court last year, *Curphey* v. *Commissioner* 73 T.C. No. 766 (1980). The Tax Court rejected the I.R.S. view and it is necessary for the Congress to affirmatively reject the I.R.S. view as well by enacting H.R. 1290 in order to prevent other taxpayers from being forced into litigation on this matter.

We support H.R. 1290 on this issue because it would make clear that the deduction for home office expenses is available where the home office is the principal place of business for a particular business conducted by the taxpayer. It is incorrect to assume, as does the I.R.S. proposed regulation, that a taxpayer can have only one principal place of business. Inflation and the general increase in the cost of living have forced many Americans to work at two or more trades or businesses and each of these trades or businesses may be conducted in a different location by the taxpayer. The tax code should not be interpreted to disallow normal business deductions if the taxpayer chooses to conduct a particular business from a home office. H.R. 1290 provides a simple solution to a burgeoning problem created by I.R.S. and, in essence, merely reaffirms the position that many believed Congress had espoused in 1976.

MAINTENANCE OF A VACATION HOME

H.R. 1290 would also clarify the 1976 Tax Reform Act with respect to the "personal use" of a vacation home by a taxpayer for repair and maintenance purposes. The Act had specified that it would not be considered a personal use of the vacation home by the taxpayer if the taxpayer was at the residence and spent substantially all of his time engaged in repair and maintenance activities. This was a sensible provision. The I.R.S., however, would now challenge this provision and consider the taxpayer to have personally used the vacation home in this situation, and thus impose limitations on the deductibility of normal business expenses, unless all others on the premises who are capable of working also spend substantially all of their time engaged in repair and maintenance activities.

Mr. Chairman, this I.R.S. position is simply not supported by the language of the 1976 Act or by any of the legislative history of that Act. The history of this provision clearly indicates an intention to apply this rule only to the taxpayer—the owner of the unit—and not to others. Further, this rule would be incapable of enforcement because there may be any number of reasons why a particular individual may not be working—the task may be physically beyond the capability of the person, for example. I understand that the Treasury is reconsidering its position on this point and I am pleased that they are willing to respond to the concerns that have been raised concerning this point.

CONCLUSION

H.R. 1290 would clarify existing law and prevent the imposition of unjust and discriminatory tax rules on taxpayers by the I.R.S. This measure deserves early consideration by the Congress and we commend the Committee for scheduling a hearing on this matter. Enactment of this measure would correct obvious inequities and we urge the Committee to support this bill.

We thank the Committee for the opportunity to present our views on this bill, which is an important matter for many taxpayers. I will be happy to answer any questions the Committee may have.

Chairman STARK. Mr. Purvis, would you like to summarize your testimony?

STATEMENT OF STEPHEN B. PURVIS, VIRGINIA BEACH, VA.

Mr. PURVIS. I am Stephen Purvis. As you know, the heading of code section 280A states: "Restrictions on Deduction for Business Use of Homes and Rental of Residences to Family Members."

Has this stopped the IRS from including all rental properties in their interpretation of the law?

No, indeed.

From a district director's office of the IRS came a letter to me stating,

When Internal Revenue Code Section 280A was enacted by the Tax Reform Act of 1976, the committee reports discussed the new provisions only in reference to vacation homes. In the statute, however, the term "vacation home" appears only in the heading of code section 280A; no mention of vacation homes appears in the body of the statute.

In interpreting the statute, the Internal Revenue Service has held that rental of houses, apartments, or condominiums to relatives falls under the provision of section 280A. So does proposing a blanket assumption of personal use on any property rented to relatives.

When did the Congress relinquish its responsibilities of decision-maker on tax policies to the IRS?

It seems that whenever the Treasury Department needs more revenue the first place they look is the homeowner. Instead of taking away all the incentives to purchase a home, as the Congressional Budget Office is recommending Congress do in their latest 80-page study, I suggest Congress look into cutting more of the fat from the ever-increasing costs of running the Federal Government.

The Budget Office believes that we would all be better off if the multibillion dollar tax breaks for housing were cut down sharply.

I cannot believe that Congress is putting the blame for high interest rates, high real estate prices, and industrial depression on the American homeowner.

I believe it is now time for Congress to once again start regulating the IRS instead of having the IRS regulate Congress.

Thank you.

[A letter follows:]

VIRGINIA BEACH, VA.,
October 16, 1981.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: In its quest to replace the Congress as decision maker on tax policy, the Internal Revenue Service has thrust upon itself the responsibility of interpreting federal law.

Code Section 280A has already been interpreted by Congress. The following quote was taken from the context of the Legislative History pertaining to the 94th Congress Tax Reform Act of 1976, including Code Section 280A:

This Legislative History "is important and indispensable in ascertaining legislative intent when the laws come up for construction and interpretation by the courts. The Legislative History is directly referenced under the law to which it pertains." The IRS has disregarded this Legislative History and put together its own regulations governing Code Section 280A.

In a letter from the Honorable G. William Whitehurst, he stated, "unfortunately, Mr. Purvis, the IRS's action against you in this regard is their interpretation of Code Section 280A of the U.S. Tax Code. It was not, however, the intent of Congress in amending Section 280A to impose penalties on individuals who rent investment property to family members."

Also, in a letter from the acting district director of the Internal Revenue Service, Mr. Kelleher described how the IRS reached its ruling on Code Section 280A. "When Internal Revenue Code Section 280A was enacted by the Tax Reform Act of 1976, the Committee Reports discussed the new provisions only in reference to vacation homes. In the Statute, however, the term "vacation home" appears only in the heading of Section 280A; no mention of vacation homes appears in the body of the Statute."

My feeling is that if Congress didn't want the Statute to reference vacation homes only, they would have changed the heading to include all properties. Also, if the IRS considered the Legislative History before they constructed their regulations of Code Section 280A, they would find reference to the term "vacation home" no fewer than 37 times.

Instead, the IRS has put aside the original intent of Code Section 280A, brought on their own regulations governing all investment properties, not just vacation homes, and added another unjust burden to the honest taxpayer.

The members of Congress are voted in and out on their ability to help the taxpayer and the government concerning many complex policies. The IRS on the other hand, is interested only in procuring vast amounts of capital to support the ever increasing costs of running the federal government.

All this can accomplish is more dissension among the American taxpayer toward the entire tax system. If this bill is passed, the IRS has stated that they could not interpret Code Section 280A the way they currently do to penalize myself and many like myself.

How long can Congress and the American citizen let the IRS construct their own policies with no regard to the hard working American?

I am preparing to petition the United States Tax Court concerning this absurd ruling. This route would benefit the entire country regarding renting to relatives.

Please make it your responsibility to regulate the IRS, not let them regulate you. Your immediate response to this matter would be deeply appreciated.

Sincerely,

STEPHEN B. PURVIS.

Chairman STARK. Thank you, Mr. Purvis.

I would just comment that the Chair is concerned with many of the things that have been discussed by the panel. I guess my question would be in light of the testimony of the Secretary this morning, were there any particular—and I think you were all present during his testimony on the various bills relating to section 280A, were there any of the suggestions for proposed regulations that bothered any of you?

For example, that a business in a home must continuously use that portion of the home the business is going to operate in, and that the business must make at least as much money as the deductions against it?

I think, as I understood his testimony, that is the gist of the regulations that will come out. Does that bother any of the panel?

Mr. BELL. Well, from our standpoint, Mr. Chairman, I think the Treasury Department's position now is much more acceptable to us.

We applaud the step forward they have taken.

We understand that it would be very difficult to ascertain if you didn't have some pretty strict requirements who was taking advantage of the law and who was not.

So I think we would be in general agreement, as long as the regulations, as proposed and agreed upon, do not, in fact, overly limit the legitimacy.

Chairman STARK. Mr. Magli?

Mr. MAGLI. We don't have any particular difficulty with the Treasury position. We are not asking for any change in the substantive rules relating to the business use of a residence.

We are simply trying to resolve the problem associated with family rentals. Obviously we would like to see the proposed regulations before any further comment.

Chairman STARK. I would too. In the family rental area, it is difficult for me to know how to treat it. For example, if you rent space to your parents, and thereby create a piece of income property where you might really not rent to anyone else, should you be permitted to deduct all your expenses?

You might not rent to your mother-in-law, but you would rent to your own mother.

I don't know how you get those sorts of things into the regulation; how you determine what is a fair rental—and I am sure in your profession there are comparable values, professional appraisals and so forth.

I would be interested, as I am sure you are, to see the regulations that come out. I hope you will comment to this committee on how you feel about them because my hope is the regulations will satisfy your industry and tax equity.

Mr. PURVIS. In my case I did rent to my mother-in-law. The only reason I bought the investment property was to give her a nice home.

Chairman STARK. In that case—was it a property that was previously rented?

Mr. PURVIS. No. I bought it from the lady who owned the house. That is the only reason I had that piece of property to start with.

Chairman STARK. Would it be easy for you to identify what you could rent it to somebody else for, do you think?

Mr. PURVIS. Yes.

I also, in my letter to the Internal Revenue Service, sent them a certified copy of fair rental on that unit by a real estate company, which at the time didn't seem to make any difference to them.

Chairman STARK. Mr. Duncan?

Mr. DUNCAN. I have no questions.

I want to thank the panel. I am sure your testimony will be most helpful.

Chairman STARK. Mr. Heftel?

Mr. HEFTEL. No questions.

I again want to thank you for your participation and we join with you in hoping that the IRS regulations will solve the problem for those who are genuinely trying to obey the law, but not be exploited by it.

Thank you.

Chairman STARK. Mr. Schulze?

Mr. SCHULZE. Mr. Chairman, I think we are in general agreement on most of the problems on this issue and I thank the panel for their testimony.

Chairman STARK. Mr. Moore?

Mr. MOORE. No questions.

Chairman STARK. I thank the panel. I wanted to take this moment to thank you very much.

I would comment before I call the next witness that in the questioning of Secretary Chapoton, the Chair was out of order in interrupting his colleague from Hawaii, Mr. Heftel. I wanted to take this opportunity to apologize on the record for interrupting his line of questioning. I will try to explain the Chair's reaction at another time.

I do apologize.

Mr. HEFTEL. Thank you, Mr. Chairman. I did not register a complaint, however. Just so you are aware.

Chairman STARK. You should have.

Mr. HEFTEL. I know, but I did not.

Chairman STARK. The next witness is Mr. Alan R. Markizon, senior vice president and general counsel of Filmways, Inc.

He is accompanied by Matthew Rosen, tax counsel.

STATEMENT OF ALAN R. MARKIZON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, ACCOMPANIED BY MATTHEW ROSEN, TAX COUNSEL, FILMWAYS, INC.

Mr. MARKIZON. Mr. Chairman and members of the subcommittee, my name is Alan Markizon. I am accompanied by Matthew Rosen of Skadder, Arps, Slate, Meagher & Flom. I am senior vice president and general counsel of Filmways, Inc., of Los Angeles, Calif., a New York Stock Exchange listed company with approximately 10,000 public shareholders. No individual owns as much as 10 percent of the outstanding equity of our company.

I want to thank you for the opportunity of testifying here today concerning the December 31, 1981, termination of the postponement of the effective date for special limitations on net operating loss carryovers (section 382 of the Code) which were enacted by section 806 of the Tax Reform Act of 1976.

The special limitations of section 382 have been incorporated by reference in section 383, which relates to investment tax credit carryovers, and the arguments for extension of the effective date apply equally to both sections. These sections deal with the situation where a company has various tax attributes such as net operating loss or investment tax credit carryovers and it merges with another company or its shareholders are bought out by another person. The rules determine the amount of the acquired corporation's losses and credits which will be available in the future.

Filmways has net operating loss and investment tax credit carry forwards far in excess of its ability to utilize them anytime soon on its current or anticipated capital base. Therefore, it is in the interest of our 10,000 shareholders that the value of these tax attributes, built by their capital, not be destroyed.

Prior to the Tax Reform Act of 1976, sections 382 and 383 already restricted the manner in which NOL and ITC carryovers could be used by successor companies. The 1976 act made these rules much more restrictive. Presumably the reason for the new rules was to stop what was considered to be unacceptable trading in tax attributes. However, for most public companies in a loss position, as a practical matter, the new rules would completely bar acquired or successor companies from any utilization of such carryover tax benefits. Citing technical problems and the need for further study of this area, Congress has twice postponed the effective date of these rules. The effective date is now January 1, 1982. To our knowledge, no reexamination has taken place and no hearings were even held in 1976. If these rules become effective, and Filmways merges or its shareholders sell out after January 1, 1982, these tax attributes will be virtually destroyed. I believe a further delay is warranted so that these new rules can truly be reviewed.

Such a review of this area is required for at least three reasons. First, no public, economic, or tax policy is well served by barring shareholders of public companies, or any other company for that matter, from obtaining some benefit from the NOL's and ITC's which their capital created. Under current sections 382 and 383, in a taxable transaction, the corporation's tax benefits would be lost only if there is both a change of ownership and a change of business. Under the new rules, continuing the business which generated the benefits would no longer be enough to preserve the tax

attributes. Compelling arguments of equity and economics lead me to urge you to consider a policy that allows a business that has generated NOL or ITC carryovers to be able to utilize those carryovers no matter who the owner is, at least so long as the business which generated them is continued. Further, it is difficult to understand a policy that bars the old owner from receiving any benefit where he or she is part of the new enterprise as the new merger rules would do.

Second, the recent tax bill and the current economic climate compel a reexamination of sections 382 and 383. The new safe harbor leasing rules are designed to stimulate the investing of capital by permitting depreciation and investment tax credits to, in effect, be sold, whereas new sections 382 and 383 create a disincentive for investment by restricting the manner in which the shareholders of a loss corporation can mitigate their losses through the transferability of tax attributes with a sale of the corporation. I am also here to suggest that the shareholders of loss companies should not suffer the additional loss of the value of their tax attributes. For some companies, current fiscal policies are increasing their loss carry forwards at the same time past tax policies would seek to restrain them from getting any value from the carry forwards. Some relief is in order.

Third, new sections 382 and 383 weight investment risk against small business, while favoring large business. Under the new law a large company can start a new enterprise and, if it has losses, reduce its taxes paid on the profitable part of its business, but the shareholders of a small company, that has only one business that is losing money will not be able to mitigate those losses by realizing some value from its tax attributes when the corporation is sold.

If your committee and the Congress would decide that the presumed goals of new sections 382 and 383 are worth achieving, I believe—and my written statement documents in detail—that the technical provisions of the new law do not work and need to be revised.

I urge a 2-year delay in the effective date of new sections 382 and 383 while the Congress examines the area in light of today's climate.

Mr. Chairman, thank you again. I will be pleased to try to answer any questions that you or the committee might have.

[The prepared statement and additional material follow:]

STATEMENT OF ALAN R. MARKIZON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, FILMWAYS, INC.

My name is Alan R. Markizon. I am Senior Vice President and General Counsel of Filmways, Inc., a New York Stock Exchange listed company with approximately 10,000 public shareholders. No individual owns as much as 10 percent of the outstanding equity of our company.

I want to thank you for the opportunity of testifying here today. I am pleased that the subcommittee is reviewing the status of Sections 382 and 383 of the Internal Revenue Code which limit the use of certain tax attributes of a corporation which is acquired by or combined with another corporation.

Filmways has net operating loss and investment tax credit carryovers in excess of its ability to utilize them anytime soon on its current or anticipated capital base. Therefore, it is in the interest of our 10,000 shareholders that the value of these tax attributes, built by their capital, not be destroyed.

Limitations on the use by an acquired or successor corporation of any losses, credits or other tax attributes which were created in years prior to the acquisition of the corporation have been a part of the tax law since 1954. The Tax Reform Act

of 1976 imposed more restrictive limitations on the availability of loss and credit carryovers than had previously been the case. However, as discussed below, it is submitted that the approach of the new rules is undesirable for several reasons.

The effective date of new Sections 382 and 383[1] (which contain the revised limitations) was postponed in 1978, and again in 1979, the Senate Finance Committee report citing "[a] number of technical problems . . . which will require consideration of additional revision of the rules" as the reason for the postponement. To date, there has not been any Congressional action to examine or correct these technical problems, and, unless Congress acts, the new limitations will generally take effect, as a practical matter, on January 1, 1982. It is the purpose of this statement to point out that it is widely recognized that a number of substantive and technical problems do indeed exist, and to urge that the effective date of the new rules be further postponed pending the thorough examination which Congress has twice declared to be necessary.

In addition, this statement will describe several developments in the tax law and in the economy occurring since 1976 which indicate that the tax policies underlying new Sections 382 and 383 are not appropriate in the current financial climate.

It is suggested that a two-year postponement of the effective date of new Sections 382 and 383 would be apropriate.

A. THE UNDERLYING POLICIES OF NEW SECTIONS 382 AND 383 ARE INCONSISTENT WITH THE ECONOMIC RECOVERY TAX ACT AND INAPPROPRIATE IN TODAY'S ECONOMY

When the new loss and credit carryover rules were enacted as part of the Tax Reform Act of 1976, it was taken for granted that the acquisition of a corporation having such carryovers was a practice which was abusive and should be curtailed. Whether or not that premise is correct, permitting the additional restrictions on loss and credit carryovers imposed by the new rules to take effect in 1982 would not be sound policy in light of the enactment earlier this year of the Economic Recovery Tax Act of 1981 ("ERTA").

Many of ERTA's provisions are designed to encourage capital formation. The accelerated cost recovery system, the "safe harbor" (or "nominal") leasing provisions and the new investment credit rules are representative of the new statutory provisions designed to effect this economic policy, and reflect the importance which Congress has placed on this objective. It is likely, however, that the limitations imposed by new Sections 382 and 383 will lead to results contrary to the capital formation intended by ERTA. For example, an entrepreneur will certainly be more likely to invest in new ventures if he is assured that, in the event the venture turns out to be unprofitable, he will be able to mitigate his loss by selling his business at a price which reflects the value of all of the business's assets, including any favorable tax attributes.[2] While some restrictions may be desirable, limitations approaching a complete bar on transferability clearly are not.

ERTA also extended the permissible carryover period for net operating losses and certain tax credits to fifteen years. In general, this reflects a policy judgment of Congress that wider availability of net operating losses should be permitted. Obvi-

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[1] Except where otherwise stated, all section references are to the Internal Revenue Code of 1954, as amended. Section 382, in both its current and revised forms, imposes limitations on net operating loss carryovers and Section 383, in both its current and revised forms, imposes limitations on carryovers of investment tax credits, capital losses, excess foreign tax credits and certain other tax attributes. The reasons for postponement of the effective date discussed in this statement are equally applicable to each of these sections.

[2] In addition, the new rules will unfairly discriminate against investment by small businesses. A large, profitable corporation that wishes to engage in a new venture can do so secure in the knowledge that if the new project is unsuccessful and generates a loss, that loss can be applied to reduce the tax liability of the corporation on its profitable operations. (Through the use of a consolidated income tax return, this is true even if the new enterprise is operated through a subsidiary rather than a division.) Similarly, an individual with sufficient means to be able to afford to put his personal assets at the risk of a new venture can operate it in noncorporate form, and thus use any losses generated to offset taxes on other income. On the other hand, a small entrepreneur who wishes to place a limited amount of capital at the risk of a new venture, but who must use the corporate form of organization to guard against the possibility of financial destruction in the event the new venture fails, will not be able to offset the new venture's losses against his other income. Unless he is permitted to sell the corporation's stock to a purchaser who (subject to the restrictions imposed by current Sections 382, 383 and 269 of the Code) is willing to pay for the corporation's tax attributes as an asset of the corporation, the economic consequences of the new enterprise's failure will be more severe than would be the case for the large corporation or wealthy individual discussed above. The inequity of imposing more adverse tax consequences upon financially troubled small businesses cannot be justified on any policy grounds.

ously, implementation of the new rules curtailing the post-acquisition use of loss or credit carryovers could frustrate this policy and should be reviewed.

The safe harbor leasing provisions of ERTA also represent a policy judgment seemingly at odds with the provisions of new Sections 382 and 383. Before the safe harbor leasing provisions of ERTA were enacted, only the owner of property would be entitled to the deductions and credits attributable to the property (with a limited exception permitting certain lessees to use the investment credit). If the owner did not have enough income to utilize the deductions and credits, he would finish the year with a net operating loss or credit carryover. In contrast, the new leasing provisions permit a transfer of depreciation deductions and investment credits by a taxpayer who has insufficient income to use them to a taxpayer who can use them, even though the latter taxpayer has none of the normal incidents of ownership of the items generating the deductions and credits. In light of this clearly expressed policy in favor of the free transferability of these tax benefits, it makes little sense to implement a provision which is designed to eliminate the loss carryovers and other tax attributes of a corporation which itself has been acquired. It would be ironic indeed to allow the "sale" of depreciation deductions and credits pursuant to a safe harbor lease while disallowing the use by an acquired corporation of its own loss and credit carryovers.

In addition, the unexpectedly high interest rates and general economic conditions of the past few years are believed to have caused net operating losses to be incurred on a much more widespread basis than previously had been the case. Accordingly, if new Sections 382 and 383 are permitted to become effective, there is a serious potential for a great many taxpayers to be unfairly penalized by the implementation of tax policies that were adopted at a time when Congress expected the range and number of persons to whom the new provisions would apply to be much smaller. This is particularly true for labor intensive companies and nonfinancial institutions that have comparatively large amounts of floating rate debt and which, because of the nature of their businesses, are not benefited by the new safe harbor leasing provisions.

B. NEW SECTIONS 382 AND 383 PRESENT SEVERAL SUBSTANTIVE PROBLEMS

Even if it is decided that loss and credit carryovers should be more limited than is the case under current law, there still remain a number of substantive problems with the new rules enacted in 1976. These problems are sufficiently serious to warrant taking the time to consider other approaches to the perceived abuse.

1. *The new limitations would have too broad an application.*—The new rules governing the carryover of an acquired corporation's losses and credits are unrealistic inasmuch as the instances in which a potential acquiror would wish to obtain less than 60 percent of the stock of a corporation having loss and credit carryovers are probably quite rare. Under the new rules, every taxable acquisition of 100 percent of a corporation's stock by an unrelated person would result in a complete disallowance of the acquired corporation's loss and credit carryovers. Moreover, it is unlikely that a purchaser would be prepared to contribute all the additional capital necessary to revive the acquired corporation's business where the purchaser has acquired less than 60 percent of that corporation's stock. In contrast, under current law, a complete disallowance of the loss and credit carryovers would occur only where the taxable acquisition of the acquired corporation is accompanied by a change of its business.

In addition, tax-free acquisitions of corporations having loss and credit carryovers could be severely discouraged under the new rules. If the acquiring corporation is substantial in size, there may be a practical obstacle to consummating a tax-free transaction in which shareholders of the acquired corporation obtain at least a 40 percent interest in the acquiring corporation. In the case of a tax-free acquisition under current law, a meaningful difference in the size of the acquired and acquiring corporations would result in a disallowance of the acquired corporation's losses and credits only where the acquisition takes the form of a merger with or transfer of assets directly to the acquiring corporation (rather than a stock acquisition or a "triangular reorganization" with a newly organized subsidiary of the acquiror in which the assets of the acquired corporation remain separate from the business of the acquiror). While one might take issue with the existing rules, the solution presented by new Sections 382 and 383 is clearly too drastic and would apply too broadly.

The application of the new rules in the context of public corporations only exacerbates these problems. The new rules, as a practical matter, would prevent the shareholders of a public corporation from obtaining any benefit from the company's tax attributes in the event of a merger or sale of the entire corporation.

2. *The new limitations will have the effect of distorting economic decisions.*—In the case of tax-free acquisitions, the new rules would have the unintended effect of discouraging potential acquisitions which otherwise would serve the interests of the shareholders of both the acquired and acquiring corporations by causing them to prefer combinations between companies that are of a size which is compatible with preserving the acquired corporation's tax attributes. If the marketplace is to be affected in this manner, it should only be after the effects have been thoroughly considered.

Besides the distortions created by limiting the class of potential acquirors to other corporations of a relatively similar (or smaller) size, the new rules would also have the unintended effect of making it less desirable for shareholders of corporations having to sell or combine their corporations with others who might operate them more efficiently or provide them with an adequate capital base, in the vain hope that the corporation's business might be turned around and produce income which could be sheltered by the corporation's own carryovers. However, if the value of such carryovers could be realized in a sale or other combination of the corporation, there would presumably be less resistance to disposing of the corporation to another person who presumably intends to operate its business on a profitable basis.

3. *The new rules represent a departure from the "entity" theory of corporate taxation.*—The new rules, unlike current law, will operate to disallow the loss and credit carryovers of a corporation where the requisite percentage of its stock has changed hands in a taxable transaction, even if the corporation continues to carry on the same business as it carried on before the change in ownership. This represents a departure from the "entity" theory of corporations which, except in rare cases, is respected throughout the law of income taxation. It is submitted that such a departure from one of the fundamental principles of our system of taxation should not be undertaken without fully examining and determining the necessity for such a step.

4. *The new limitations misconceive the purpose of the loss and credit carryover provisions.*—The purpose of the loss and credit carryover provisions is to relieve taxpayers of the hardships that may flow from the use of an annual system of tax accounting. Contrary to this objective, the new rules will disallow carryovers precisely when such relief from the annual tax system is most necessary. One alternative to the new rules which would further the policy of eliminating hardships attributable to the annual accounting method would be to build into the test for whether loss and credit carryovers survive an acquisition the requirement that, in some meaningful sense, the business which seeks to use the carryovers must be the same business which generated them. As the United States Supreme Court said in the famous *Libson Shops* case,[3] the net operating loss carryover is designed to deal with "the fluctuating income of a single business"; clearly a mere change in stock ownership does not result in a corporation being any less of "a single business."

C. THE NEW RULES HAVE SEVERAL SERIOUS TECHNICAL DEFECTS

Even if it is determined that the approach of the new rules is sound as a policy and substantive matter, there remain a number of technical defects in the rules which are discussed in detail in the New York State Bar Association Tax Section Report on Section 382 of the Internal Revenue Code as Amended by the Tax Reform Act of 1976 (the "Bar Association Report"), a copy of which is attached as Appendix A. The more serious of these technical problems include the following:

1. The interplay between new Sections 382 and 383 and the consolidated return regulations is very unclear. The consolidated return regulations contain a number of limitations on the use of carryovers of one member of an affiliated group against the tax liability or income of other group members. The failure to coordinate the provisions of new Sections 382 and 383 with the consolidated return regulations creates a great deal of uncertainty and complexity in the interpretation and application of the new rules.

2. The attribution rules to be applied in connection with new Sections 382 and 383 are different for taxable and tax-free acquisitions. This lack of symmetry has the effect of treating differently taxpayers who are similarly situated, without any basis in policy for the different treatment.

3. Commentators have suggested that the different rules applied by new Sections 382 and 383 to taxable and tax-free acquisitions involving related parties are unnecessarily complex and again without any support in policy.

4. The new rules are extremely confusing in their definition of the types of equity interests ("stock" and "participating stock") which are to be taken into account in

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[3] 353 U.S. 382 (1957).

determining when the new rules apply. It is submitted that this aspect of the statutory scheme is both cumbersome and unnecessary.

5. New Section 382 is needlessly complex in describing the types of taxable acquisitions to which it applies. There is no apparent explanation for this complexity which undoubtedly will lead to mistakes and uncertainty in application.

6. Unlike prior law, the new rules apply to changes in ownership resulting from "B" (stock-for-stock) reorganizations. Although the principle may be sound, the language used is difficult to understand; and the Bar Association Report states, in the absence of the legislative history, "[t]his provision defies interpretation."

D. THERE IS NO NEED FOR IMMEDIATE IMPLEMENTATION OF THE NEW RULES

Lest the suggestion be made that immediate implementation of the new rules is necessary as a revenue matter, it should be noted that when the new rules were last postponed in 1979, the revenue effects of the two-year postponement were estimated by the Senate Finance Committee to be less than $5 million annually.

In addition, it is noted that current law already contains limitations dealing with the problem of "trafficking" in loss and credit carryovers. Current Sections 382 and 383 contain a series of mechanical rules for disallowing losses and credits, and Section 269 reinforces these limitations by disallowing losses and credits where an acquisition is principally made for the purpose of avoiding or evading taxes. However, neither the form of the corporate income tax return nor the Internal Revenue Service's audit procedures are designed to elicit effectively the information necessary to enforce these se tions. As suggested in the Bar Association Report, a policy of strictly enforcing the existing laws could be as effective in generating additional tax revenue as would the new rules.

E. CONCLUSION

When first enacted in 1976, new Sections 382 and 383 were approved without a critical examination of the issues they presented: whether it is sound economic policy to further limit the use of an acquired corporation's loss and credit carryovers and whether new legislation is an appropriate means of bringing this about. In light of these questions, and particularly in light of the serious policy, substantive and technical problems presented by this complex set of new rules, it is submitted that a two-year delay is necessary in order carefully to reexamine the new rules in light of today's circumstances and, if considered desirable, to redefine the solution.

[Attachment]

Report on Section 382 of the Internal Revenue Code as Amended by the Tax Reform Act of 1976

New York State Bar Association, Tax Section, Committee on Corporations*

I. INTRODUCTION

This report is designed primarily to make recommendations for the revision of section 382 of the Code as amended by the Tax Reform Act of 1976.[1] The bulk of this report accepts the basic policy judgment that tightening restrictions on "trafficking" in loss carryovers and other tax benefits is desirable and then discusses methods of improving section 382 both in basic concept and in important details.

Before proceeding with that task, the committee wishes to draw attention to the obvious fact that "new' section 382 was decided upon and enacted with little or no public discussion and particularly with no serious public consideration of its basis premise, *i.e.*, that drastic new legislation is necessary to limit trafficking in loss carryovers. We think it appropriate to examine that premise and consider whether new legislation, or indeed any legislation, is necessary in this area.

A. Is new legislation necessary?

The fundamental premise underlying new section 382 is that a change in the statutory machinery is necessary to restrict undue trafficking in net operating loss carryovers and other tax benefits. Yet none of the committee reports adduces any

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*This report was drafted by a subcommittee chaired by Arthur A. Feder and consisting of Richard H. Nicholls, Willard B. Taylor and Lee S. Parker. The report benefited from extensive comments by Eugene L. Vogel, Chairman of the Committee on Corporations.

[1] Pub. L. No. 94-455, § 806(c), 90 Stat. 1520 (1976). Section 8 of the Tax Treatment Extension Act of 1977, H.R. No. 9251 introduced on September 22, 1977, and passed by the House on October 26, 1977, delays until 1980 the effective date of new section 382.

facts to demonstrate that there is significant "trafficking" in carryovers under present law. Moreover, the committee reports state that the revenue effects of these amendments are "uncertain"—which certainly suggests that trafficking, to the extent it exists, may have no great revenue effects.[2]

In the absence of published statistics showing that any great abuse occurs in this area, we doubt that the enormous addition to the complexity of the Code inherent in doubling the length of section 382 is worthwhile. We would suggest that doubling the length of a Code provision probably leads to a fourfold increase in the problems of its interpretation. The new statute, even before it has come into effect, is improving in a minefield of interpretative problems.[3] We doubt very much that the extension of the carryover period from five to seven years creates enough added risk of abuse to justify this additional complexity.

If there is excessive trafficking in the stock of corporations having net operating loss carryovers and other carryovers, we question whether this trafficking might not be dealt with more effectively by leaving the previously existing provisions in place but proceeding with a publicly announced approach of "tough" enforcement.

The corporate tax return does not now serve to alert an examining agent to the occurrence of a section 269 or 382 transaction.[4] It might be desirable to require a corporation using a net operating loss or other carryover to indicate on its return whether a change of ownership as defined in section 269 or 382 has occurred. Returns which indicate that such changes have occurred could then be given more intensive scrutiny in the audit selection process.

Present audit procedures might also be tightened by instructions in the audit manual requiring specific answers by agents to a question as to whether the possible application of sections 269 and 382 has been considered wherever a loss or other carryover in excess of some specified amount has been utilized.

In addition, the Service might well audit more aggressively any corporate return showing a substantial deduction for a net operating loss carryover. Such returns might be readily selected for audit by computer. We understand that such corporations frequently are ignored for audit purposes as long as the carryovers more than cover present income. Moreover, an examination of the publicly available audit manuals shows little that would lead an agent to be especially alert to this type of transaction. Thus, the question of whether sections 269 or 382 might be applicable frequently is never raised on audit.

We would suggest that, frequently, a public warning of an aggressive audit policy will do more to limit abuse transactions than any amount of additional legislation, particularly when a fairly rigorous set of restrictions already exists.

B. Should there be a free traffic in net operating loss carryovers?

Before the restrictions on trafficking in carryovers are tightened some consideration should be given to the substantial arguments that can be made for permitting free traffic in net operationg loss carryovers. At present, entrepreneurs who offset losses from one line of business against another existing line of business or against other sources of income in effect receive a government subsidy for an unprofitable enterprise which is not available to others who cannot so offset their losses. Allowing free transferability of loss carryovers would make the subsidy to all entrepreneurs essentially the same. It would also be a dramatic help for those trying to raise capital for new venture capital businesses.

In fact, an enormous trade in corporate tax benefits now operates through the equipment leasing market, where investment tax credits and accelerated depreciation are transferred to taxpayers better able to utilize such benefits than the lessees of the equipment, apparently with complete Congressional approval. We believe that the annual totals of tax benefits transferred from one corporation to another in that market exceed many times over the tax benefits "trafficked" by sales of stock of loss corporations.

The bias of present law in the net operating loss area may be seen by examining the case of three groups that set out to develop and market a computerized mousetrap, each investing and losing $10,000,000 in the project.

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[2] *See* S. Rep. No. 938, 94th Cong., 2d Sess. 200-07 (1976); H.R. Rep. No. 1515, 94th Cong., 2d Sess. 448-51 (1976). *See also* Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 204-05 (Comm. Print 1976) [hereinafter cited as General Explanation].

[3] *See* Association of the Bar of the City of New York, Committee on Taxation, Statement on Section 806(e) of the Tax Reform Act of 1976 (1976) [hereinafter cited as Association Statement]; *The Tax Reform Act of 1976: Loss Carryovers and Other Corporate Changes*, 32 Tax L. Rev. 113, 113-44 (1977).

[4] Question H(2) asks only whether any person or attribution group (using section 267(c) rule for this purpose) owns 50 percent or more of the stock of the corporation. This would not serve to alert an agent to the possible occurrence of a section 269 or section 382 transaction.

A Corp. is a subsidiary of General Inventions, Inc., which has pretax income of $10,000,000 a year and intends to file a consolidated return.

B Corp. is a corporation which has raised $10,000,000 from a group of fifty investors.

C Corp. is owned by ten wealthy individuals who as a group have taxable income of $5,000,000 a year.

In A's case a loss of $10,000,000 results in an immediate $5,000,000 reduction in tax liability of General Inventions, Inc., in addition to the speculative possibility that some capital gains tax reduction may be obtained at the shareholder level reflecting the $5,000,000 net economic loss.[5]

B's loss produces only a $10,000,000 capital loss at the shareholder level which is of speculative utility for most taxpayers. Both "new" and "old" section 382 would severely inhibit any effort to pass B's loss carryover to third parties and, in practical effect. B's shareholders will be out of pocket by the full $10,000,000, without any tax relief.

C's losses are likely to be passed through to its investors pursuant to subchapter S, and produce tax benefits of between $5,000,000 and $7,000,000.

Is there any sense in a situation in which the investors are in effect able to recoup $5,000,000 to $7,000,000 of their investment from the federal coffers in the first and third cases, but not in the second?[6] Permitting free trade in the stock of corporations having net operating loss carryovers would put all three groups of investors in parallel economic situations.

If there were a free trade in the stock of corporations having net operating loss carryovers, the investors would sell B corporation to a third party or merge it with another corporation. The acquiring person presumably would be willing to pay something approximating 48 percent of the net operating loss carryovers, discounted primarily for the time which would be required to utilize the loss. In effect, free trade in net operating loss carryover corporations would substantially reduce the possibility of "windfalls" for buyers which the General Explanation suggests as the basic reason for the present prohibitions or limitations on transfers of interests in loss corporations.[7] Owners of loss corporations would be able to obtain higher prices on sales of their stock if it were known that the corporation's carryovers were clearly usable.

We believe there is much to be said, therefore, for free trade in the stock of corporations having net operating loss carryovers, and we further believe that the possibility of extending this analysis to other carryover items also deserves consideration, particularly because these items seem unlikely to play a major role in shaping transactions for tax avoidance purposes.

II. SUBSTANTIVE PROPOSALS RELATING TO LIMITATION OF "TRAFFICKING" IN LOSS CARRYOVERS

The balance of this report accepts the basic policy decision that trafficking in losses should be controlled, and that new legislation is necessary. The remainder of this report first makes recommendations for basic changes in section 382; next considers other areas in which legislation is appropriate as part of an overall approach to the problem of trafficking in losses, and then makes technical and drafting suggestions to improve and simplify section 382. Finally, Appendix A to this report is a rough draft representing one approach to a simplified and integrated section 382.

A. Use of carryovers in the same trade or business

Prior to the Tax Reform Act of 1976, carryovers were allowed under section 382(a) unless, in addition to a change in ownership, there was a change in trade or business (i.e., the corporation did not continue to carry on a trade or business "substantially the same" as that previously conducted).[8] While section 382(b) did not contain an explicit "trade or business" test, the inapplicability of that provision to "B" reorganizations and the special rules relating to triangular reorganizations can be viewed as incorporating a modified trade or business test, since the effect was to allow the carryover if the assets of the corporation with the carryover remained in a separate corporation which acquired no other major assets in the reorganization.

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[5] *See also Textron. Inc.* v. *United States* ¶77-2 USTC ¶9539, at 87,804-07, 40 AFTR 2d 5452, 5453-36 (1st Cir. 1977) (taxpayer obtained equivalent of $10,000,000 in tax savings in analogous situation).

[6] An expansion of subchapter S to cover corporations with more shareholders is not likely to meet B's problem in view of the complexities of that provision.

[7] General Explanation, supra note 2, at 191-93.

[8] I.R.C. §382(a)(1)(C) (1954).

The Tax Reform Act of 1976 eliminated change in trade or business as a criterion under section 382(a), the exception in section 382(b) for "B" reorganizations and the special rules under section 382(b) for triangular reorganizations.

In the committee's view, a change in the ownership of a corporation should not result in a disallowance of its carrovers under either section 382(a) or section 382(b) if there is adequate assurance that the carryover will only be used against tax liabilities generated by the business that gave rise to the carryovers. This rule would be an exception to the general rule that disallows carryovers when there has been the requisite change in ownership. Any difficulty in policing and enforcing the exception would be handled by requiring the taxpayer to establish that the exception applied and by writing the exception to allow a carryover only if and to the extent used to reduce a tax liability attributable to the same business that gave rise to the carryover (i.e., the exception would be substantially narrower than the discontinuance of trade or business rule in old section 382(a)).[9] If in an "A" or "C" reorganization the business with the carryover ended up in a corporation which conducted other businesses, the taxpayer would be required to keep the records necessary to segregate the business of the carryover corporation from that of such other businesses.[10]

B. Section 269

The legislative history of the Tax Reform Act expresses the intent of Congress that section 269 not be applied to disallow carryovers allowed under new section 382 "unless a device or scheme to circumvent the purposes of the carryover restrictions [of Section 382] appears to be present."[11] This expression of intent is substantially diluted, however, by a subsequent statement that the "device" exception will apply "where a permanent interest by former owners of a loss company is diluted for tax avoidance purposes."[12]

It is difficult to give meaning to these statements without examples. Suppose, for example, that X corporation, with a substantial net operating loss and insubstantial assets, is merged into Y corporation. Assume that Y is essentially interested in X's loss and that the shareholders of X extract, as the price for such loss, 45 percent of Y corporation's "participating stock" and "stock." The section 382 limitation is not discussed during the negotiations.

Neither the language nor the legislative history of the Tax Reform Act indicates whether the tests of section 269 were meant to apply to this case or a case in which Y's shareholders receive only 35 percent of Y's "stock" and "participating stock." Moreover, it is not clear whether the answers to these questions would be different if the parties had considered section 382.

Unless Congress intended that section 269 be inapplicable in each of these cases, we doubt that the statements in the legislative history have much value. In the committee's view, the legislative history will simply shift arguments under section 269 to the issue of whether or not there was a "device" to avoid new section 382. Once a policy decision is reached to limit trafficking in losses, moreover, there is no reason why tax-motivated transactions should be successful simply because they satisfy the requirements of section 382. Accordingly, the statements in the General Explanation with respect to section 269 should be disavowed.

Alternatively, the Code itself should be amended to preclude the application of section 269 to any transaction subject to the tests of section 382, whether or not that section actually reduces a carryover.[13]

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[9] The standard of proof imposed would be comparable to that imposed on taxpayers seeking to satisfy the tests of Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957), under the 1939 Code: "Further, the taxpayer has the burden of establishing the correctness of the amount claimed as a net operating loss deduction or unused excess profits credit. Even after a statutory merger or consolidation subject to the 1939 Code, if the records of the resultant corporation are not maintained in such manner as to enable the Internal Revenue Service to make a reasonably conclusive determination as to the part of such deduction or credit allocable to the portion of the business of the resultant corporation conducted with the assest of the merged constituent, the claim will be regarded as having failed for lack of proof and will be disallowed." Rev. Rul. 59-395, 1959-2 C.B. 475, 479.

[10] A more limited alternative than that recommended by the committee would restore the exception under prior law for "B" reorganizations and the special rules for triangular reorganizations in which the corporations with the carryover ends up as a separate corporation with substantially no new assets. This might be simpler to administer, but it would not cover other forms of reorganizations.

[11] General Explanation, supra note 2, at 203.

[12] Id. at 203 n. 32.

[13] Other recommendations for the amendment of section 269 are made in part II(D)(3) infra.

C. Non-linear reduction

Prior to the Tax Reform Act of 1976, section 382(b) reduced carryovers by 5 percent for each percentage point of the surviving corporation's stock under 20 percent that was owned by stockholders of the corporation having carryovers. Section 382(a) eliminated the entire carryover if there was the requisite change in ownership and in trade or business. The Tax Reform Act raised the section 382(b) percentage from 20 percent to 40 percent and introduced the concept of proportionate reduction under section 382(a). In each case, the Act provides for a non-linear reduction—i.e., a 3½ percent decrease in the carryover for the first 20 percentage points under 40 percent and a 1½ percent decrease in the carryover for the second 20 percentage points.

The legislative history attempts to justify this non-linear reduction by analogy with other provisions of the Code (such as affiliation for consolidated return purposes under sections 1501-05, tax-free liquidations under section 332, and "control" for purposes of corporate reorganizations under section 368(c)), all of which put a premium on 80 percent ownership and attach little or no significance to the ownership of the remaining 20 percent of the corporation's stock.[14] It seems to the committee, however, that analogies with other Code sections are unpersuasive, and that, in terms of the policy of section 382, there is no good reason to distinguish between the first 20 percentage points and the second. At the same time, the 3½ percent—1½ percent structure adds complexity. We recommend, therefore, that the reductions in the carryover items be linear (i.e., 2½ percent for each percentage point over 60 percent). Alternatively, we would recommend that available carryovers be reduced at the rate of 3½ percent for each percent of change in excess of 60 percent, even though it would result in complete disallowance short of a 100 percent change in ownership.

D. Concepts of control and common control in sections 382(b) and 269

In general we approve of the attempt to make new sections 382 (a) and (b) more closely parallel so that differences in the form of transactions will not result in significant differences in the availability of carryovers. Further improvement should be made, however, in the application of section 382(b) to multi-tier structures and in the concepts of "control" and "common control" as used in section 382(b). Moreover, such concepts should be coordinated with those of section 269.

1. Section 382(a) limits a net operating loss carryover available at any level of a multi-tiered corporate structure if the requisite change in ownership occurs even indirectly, e.g., if a more than 60 percent change of ownership in the stock of a corporation occurs and its wholly-owned subsidiary or second-tier subsidiary has a net operating loss carryover. Moreover, for purposes of section 382(a), changes in the ownership of one corporation's stock are relevant in determining whether the requisite change of ownership has occurred with respect to any other corporation in which the first corporation owns any stock, directly or by attribution.

The limitations of new section 382(b), however, apply to a subsidiary of a corporation participating in a reorganization only if the acquiring or acquired corporation "controls" the subsidiary. The use for this purpose of the section 368(c) definition of "control" opens several potentially significant loopholes. If P merges with X, and S, a 78 percent owned subsidiary of P, has a net operating loss carryover, section 382(b) will have no affect whatsoever on S's net operating loss carryovers. If P has a 100 percent owned second-tier subsidiary, S_2, which has an available net operating loss carryover, a merger of P into X will not reduce S_2's loss carryover.

2. Under new section 382(a), a transaction which does not result in the requisite change in the beneficial ownership, actual or constructive, of a corporation will not result in a reduction of a net operating loss carryover.[15]

By contrast, under new section 382(b), as under prior law, the substantial common ownership of two merging corporations by the same group of shareholders does not preclude application of the loss limitations unless "the same persons own substantially all the stock of the acquiring corporation and of the other corporation in substantially the same proportions."[16] Similarly, while the common control exception was broadened to apply to reorganizations involving second-tier controlled corporations, if, say, A owns B directly and C through two tiers of subsidiaries, the exception will apparently not apply because the concept of control is too narrow. Such strict limitations cannot be justified in the context of a statute which generally allows a 60 percent change in ownership without limitation of losses.

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[14] *See* General Explanation, supra note 2, at 193.

[15] I.R.C. § 382(a)(5)(A).

[16] I.R.C. § 382(b)(6)(A). This exception has been read strictly by the courts. *See* Kern's Bakery of Virginia, Inc., 68 T.C. No. 44 (July 18, 1977); Commonwealth Container Corp., 48 T.C. 483 (1967), aff'd, 393 F.2d 269 (3d Cir. 1968).

Both these types of problems (one operating unfairly in favor of taxpayers and the other unfairly against them) could be resolved and sections 382(a) and (b) made more parallel by recasting section 382(b) in terms of a change in actual or constructive ownership. In other words the limitations would not come into play unless the percentage of shares held by the actual or constructive owners of the loss corporation was reduced to less than 40 percent of the value of the combined corporation. It would be immaterial whether the shares were acquired in the reorganization or were held previously.

Under this approach, section 382(b) would apply to all levels of a multi-tiered corporate structure. As with section 382(a), it would be immaterial whether a first-tier or a tenth-tier subsidiary suffered the loss. Under these circumstances, there would be very little need for the consolidated return regulation provisions limiting use of losses in situations involving consolidated return changes of ownership, reverse acquisitions and acquisitions of an old group by a new group.

3. Many transactions excepted from the scope of section 382(a) by section 382(a)(5) would seem to be subject to the tests of section 269. The Congressional judgment that loss carryovers should be unaffected by such transactions would be frustrated if section 269 were applied to the transactions and a sufficiently strong business purpose could not be established. For example, a transaction in which creditors or employees take control of a corporation is free of the restrictions of section 382(a) but within the possible ambit of section 269.

Moreover, section 269 itself contains only very limited common control exceptions. Thus, for example, an upstream merger of subsidiary into parent is free of section 269, while a downstream merger is not.[17]

Accordingly, we recommend that constructive ownership rules applicable to section 382(a) and exceptions paralleling those of section 382(a)(5) be incorporated into section 269.

E. Built-in losses

The General explanation states that "section 269 is retained for example to deal with 'built-in-loss' transactions . . . ."[18] The application of section 269 to built-in-loss transactions has been uncertain in the past, and the legislative history of new section 382 does not provide much additional guidance.[19] Assuming a policy decision to limit "trafficking" in losses, the committee believes that the question of built-in losses should be dealt with expressly and that the concepts of section 382 are appropriate for this purpose.

In our experience, built-in losses are not typically a major factor in the trafficking in losses. On the other hand, there are instances in which the tax basis of the assets of a corporation so far exceeds the value attributable to such assets that the ability to continue depreciating at an artificially high level or to dispose promptly of the assets at a larger loss may become a significant factor in the transaction. In these extreme cases, it is difficult to distinguish between a loss realized prior to (or within three years of) a change in ownership, which is presently covered by section 382, and a built-in loss recognized more than three years after that change, to which section 382 does not now apply.

For purposes of defining built-in losses to which section 382 would apply, it is important to distinguish between those instances in which the built-in losses are so substantial as to be a significant motivation in the transaction, and the more ordinary case in which there is some variation between the basis and the value of the assets but the overall impact is not that significant. Accordingly, we would recommend that built-in losses be deemed to arise only in instances where the total consideration attributable to all of the assets acquired is significantly less than their tax basis. The test should not be applied asset by asset. There may be significant variations in value as compared to basis of particular assets, but if, overall, the consideration paid is not very substantially out of proportion to the overall value of the package of assets obtained, tax-avoidance motivations are unlikely to play an important role in shaping the transaction.

In addition, and for the same reasons, we believe that the threshold test for built-in losses should be fairly high. We would recommend therefore that built-in losses not be deemed to arise unless the tax basis of the assets is at least 50 percent higher than the value of the consideration attributable thereto.

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[17] *See* Reg. § 1.269-3(c)(2).

[18] General Explanation, supra note 2, at 203.

[19] The legislative history indicates only that built-in loss transactions are not expressly within the fixed rules of section 382, and that section 269 limits should be retained as a result to deal with such exploitation devices devices. General Explanation, supra note 2, at 203.

F. Consolidated return regulations

The committee believes that the rules of section 382 and the limitations on losses contained in the consolidated return regulations [20] should be harmonized. Briefly summarized, the principal limitations in the consolidated return regulations are the following:

1. *Separate return limitation years.*—With some exceptions, a loss carryover from a separate return year can be applied only against income of the loss member. Loss carryovers arising in years before a corporation became a member of a presently existing affiliated group can be used only against income of that corporation.[21]

2. *Consolidated return change of ownership.*—If the persons described in section 382(a) increase their percentage ownership by 50 percent by purchase or redemption, a consolidated return change of ownership occurs.[22] Thereafter, losses of the old group may be used only against income of the old members of the group.[23]

3. *Reverse acquisition.*—If one controlled group acquires another, and as a result the shareholders of the acquired group obtain more than 50 percent of the stock of the acquiring group, the acquiring group terminates and any carryovers from an individual member of that group may thereafter be used only against the income of that member.[24] Similar limitations apply to "built-in losses" and other items.[25]

While these provisions can be summarized in simple fashion, their application is complex, and the application of limitations to particular corporate entities encourages manipulation through the transfer of properties. It appears to the committee that the tests imposed in these regulations are not consistent with the approach of new section 382, and at least should be modified so as to be brought in line with that section. More important, since section 382(a) applies at all levels of a multi-tier corporate structure, if section 382(b) is amended so as to apply and section 382 is made applicable to "built-in losses," there would appear to be little remaining need for the rather artificial consolidated return regulation limitations described above. They then could be eliminated.

III. TECHNICAL AND DRAFTING SUGGESTIONS

A. In general

The committee believes that new section 382 is unduly prolix and that this prolixity multiplies the potential questions of interpretation that the section will generate. Moreover, to the extent that the provision is difficult to understand, taxpayers will tend to decide questions of interpretation in their own favor, assuming that the Service will or may fail to discover that a change of ownership has occurred. We fully understand that there simply was no opportunity for more careful drafting in the short period of time that was available for this purpose in 1976. It is our belief, however, that the statute could be considerably simplified and materially increased in effectiveness by substantial redrafting. A draft of one approach to the goal of a simplified statute appears as Appendix A.

Part of the price of reducing complexity may be that some potential problems are left unresolved in cases where abuse transactions are possible in logic but not probable in practice. Drafting frequently becomes unduly complex when the draftsmen attempt to cover the most extreme possible situations. The effect is not unlike that faced in insulating a building, where a 95 percent reduction in heat loss can be achieved for 2X dollars but a 99 percent reduction may cost 10X dollars. In section 382, the difference between eliminating 95 percent and 99 percent of potential abuse is at least a doubling of complexity.

For example, the statute is unduly complicated by the additional language introduced to extend section 382(a) to situations in which there are changes in the ownership of partnerships which own stock in corporations.[26] We question whether the Service has knowledge of any signficant number of cases where this technique has been used to avoid the reach of existing law. The members of this committee and others with whom they have spoken having general experience in the area do not know of any such cases. We would suggest that the commercial opportunities for such transactions are remote and that their prevention is not worth the additional complexity added to a statute of general application, particularly if section 269 continues to be available in abuse situations.

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[20] Reg. §§ 1.1502-1. et seq.
[21] Reg. § 1.1502-1 (f), 21(c).
[22] Reg. § 1.1502-1(g)(i).
[23] Reg. § 1.1502-21(d).
[24] Reg. § 1.1502-75(d)(3).
[25] Reg. § 1.1502-15.
[26] I.R.C. § 382(a)(1)(C) (ii) and (vi).

B. "Stock" and Participating Stock"—section 382(c)

The committee believes that a single definition should be substituted for the present "stock" and "participating stock" definitions of new section 382(c). The dual provisons, apparently intended to solve a particular problem, are unnecessary. In the committee's view, the Commissioner's power to distinguish between real and apparent equity interests by regulation is sufficient to prevent abuse. The dual approach not only adds significant bulk to the statute but also generates a new set of esoteric problems in distinguishing between the overlapping concepts of "stock" and "participating stock."

Apparently the concept of "participating stock" made its appearance here because of concern that, under prior law, voting but otherwise orthodox preferred stock could be given to shareholders of the loss company in a reorganization without any resulting limitation on the loss carryovers of that corporation.[27] Since the voting preferred stock was considered "stock," the losses would carry over if the value of such preferred stock met the 20 percent requirement, even though the loss corporation shareholders were apparently considered to have received no real equity participation in the continuing enterprise.[28]

Perhaps the use of both the "stock" and "participating stock" concepts was designed to preclude the reverse situation, where new interests might somehow purchase orthodox voting preferred stock of a loss corporation in order to avail themselves of its loss carryovers. If receipt of such stock in a reorganization is insufficient to allow continuance of the carryover, however, it is difficult to see why purchase of such stock in the reverse situation preclude use of the carryovers. We think a particular equity interest should either be of a type which is taken into account or not taken into account, and the power of the Commissioner to issue regulations realistically categorizing particular and unusual situations should be sufficient to prevent abuse.

The statute at present will require every corporation with more than ordinary common stock outstanding to analyze each transction not only in terms of changes in overall ownership but also to distinguish changes in stock interest from changes in participating stock interests. In many instances, it undoubtedly will be very difficult to distinguish stock from participating stock, since the definition of participating stock is quite unclear and overlaps to an uncertian extent with the definition of stock.

Under one possible reading of the definition of participating stock, the only stock that is not also participating stock is voting preferred with a fixed liquidation preference and dividend rate. If that had been intended, the statute could have expressed this thought more directly by simply so stating.

There are other difficulties with the definition of "participating stock". For example, if stock represents an interest in assets which is limited in the specified manner but the interest in earnings is not so limited or vice-versa, is the stock participating stock? [29] Similarly, if the stock is limited by any one of the types of formulas enumerated but not by any of the others,[30] it appears that the stock would not be participating stock. It is easy, however, to imagine limitations of the specified type that in no way would realistically preclude participation in the growth of the corporation. For example, a limitation expressed as a multiple of paid-in-capital would satisfy the requirement of the provision, yet contain a real element of participation. Finally, the definition of participating stock is ambiguous as to the status of convertible stock or debt. There is a substantial sense in which the interest in earnings and assets represented by convertible stock or debt is not limited by any one of the formulas enumerated.

As compared to the participation stock definition, the definition of "stock" ("all shares of stock, except stock which . . . does not participate in corporate growth to any significant extent . . ."[31]) appears to be a better articulation of what apparently was intended as a similar concept, particularly when combined with the other

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[27] S. Rep. No. 938, supra note 2, at 205.

[28] General Explanation, supra note 2, at 202 n.29 and accompanying text.

[29] The ambiguity is not clarified by the statement in the legislative history that participating preferred stock may or may not be participating stock. *See* General Explanation, supra note 2, at 202 n.30.

[30] The statute defines participating stock as stock "which represents an interest in the earnings and assets of the issuing corporation which is not limited to a stated amount of money or property or percentage of paid-in captial or par value, or by any similar formula." I.R.C. § 382(c)(2).

[31] I.R.C. § 382(c)(2).

elements of the definition.[32] In addition, the concept has the advantage of having been used before.[33]

The need to resolve all the ambiguities involved in determining whether an instrument is stock or participating stock, as well as in determining whether it is stock in the first place, is not apparent to the committee. We believe it should be possible to develop a single definition based on the present definition of stock (treating conventional voting preferred stock in whatever way is desired) which, combined with the power to prescribe regulations realistically evaluating particular instruments, should be sufficient to resolve substantially all of the problems in this area.

To summarize, the cause of simplification is hardly served by introducing the unsatisfactory concept of "participating stock" for the relatively narrow purpose of backstopping a provision aimed at a relatively rare abuse under a single section of the Code.

C. Types of acquisition covered by new section 282(a)—sections 382(a)(1)(C) and 382(a)(5)

Section 382(a) could be simplified greatly by providing that all increases in the percentage ownership by the specified persons other than those increases arising out of reorganizations or pursuant to certain enumerated exceptions are to be taken into account. At present, section 382(a)(1)(C) covers, with the exception of reorganizations, the vast majority of circumstances under which a direct or indirect interest in stock of a corporation may be increased. Yet section 382(a)(5) provides a set of exceptions which do not correlate well with the transactions covered by section 382(a)(1)(C).

Very few transactions other than reorganizations are excluded from section 382(a)(1)(C), and to some extent the exclusions may have been partly inadvertent. For example, section 382(a)(1)(C) covers a purchase of an interest in either a trust or a partnership which owns stock. While an acquisition by or liquidation of a partnership is covered, acquisitions by, and liquidations of, trusts are not. The reason for the difference is not apparent. Similarly, while the liquidation of a partnership is covered, the liquidation of a corporation owning stock in the loss corporation is not covered. In both cases, the appropriate test would appear to be whether the transaction results in a change in indirect ownership. Under the statute however, a nonprorata liquidation of a partnership would be taken into account, whereas a nonprorata liquidation of a corporation would not be taken into account.

Aside from these types of indirect changes in ownership, it is difficult to envision many types of changes in stock ownership which would not be taken into account under section 382(a). A transfer of stock for services might be one such case. A gift or inheritance of stock would be another, but such acquisitions of stock would generally be excluded by section 382(a)(5)(B).

Accordingly, the committee recommends that section 382(a)(1)(C) be amended by deleting its enumeration of specified types of transactions, and that section 382(a)(1)(B) and (C) be revised to apply in all instances where there are increases in percentage ownership except in the case of reorganizations and except as otherwise specifically excepted in section 382(a)(5).

The approach suggested by the committee would allow deletion of the mention of the term "purchase" in section 382(a)(4), but would require deletion of a section 303 redemption exception in section 382(a)(5).

Whether or not this suggestion is adopted, section 382(a)(5) should be redrafted. It is now worded too narrowly since it only excludes transactions which are "acquisitions." New section 382(a)(1)(C), however, reaches almost all indirect increases in percentage interest. For example, assume that Father and Son own 70 and 30 percent, respectively, of a corporation's stock and that all of Father's stock is exchanged for non-voting preferred stock in a recapitalization. It would appear that none of the exceptions provided by section 382(a)(5) are applicable since neither Father nor Son has made an "acquisition." This weakness in the statute might be eliminated by amending the prefatory language of section 382(a)(5) to refer to any increase in percentage points arising from the transactions specified therein.

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[32] Section 382(c) defines "stock" as, all shares of stock except stock which—(A) is not entitled to vote, (B) is fixed and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) "has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock . . ., and (D) is not convertible into another class of stock."

[33] *See* Reg. § 1.305-5(a), ("preferred stock" defined as stock which "enjoys certain limited rights and privileges . . . but does not participate in corporate growth to any significant extent").

D. Minimum ownership rule—section 382(a)(3)

The first sentence of this provision is intended to avoid reduction of carryovers from a year in which there has been substantial continuity of ownership during the last half of the year. It has been questioned whether the provision works properly.[34] We question whether this concept is worth the effort. In a particular case, the loss might be incurred entirely in the first half of the year prior to a change in ownership which occurred near the end of the first six months. In another case, the loss might be incurred in the second half of the taxable year following a change in ownership in the seventh month. The provision is objectionable because it may well have capricious results and because it adds to the Code's complexity; we believe there is no reason to deviate from the taxable year concept. The losses in the year a 382(a) increase in ownership occurs either should be allowed or they should not be allowed.

A second rule of new section 382(a)(3) provides in effect that all changes of ownership during a corporation's first taxable year are to be disregarded. This rule could be more directly expressed by simply stating that section 382(a) is inapplicable to increases in ownership during a corporation's first taxable year.

E. Certain stock for stock reorganizations—section 382(b)(5)(A) and (B)

This provision defies interpretation. The General Explanation indicates, however, that the purpose is to cover a "B" reorganization in which less than all of the stock of the loss company is acquired.[35] In a reorganization in which all of the stock is acquired, the general rule of section 382(b)(1) apparently works properly and requires no special rule. Sections 382(b)(5)(A) and (B) provide special rules, however, to cover cases in which some of the shareholders of the loss corporation do not exchange their shares or in which stock of the loss corporation was acquired by the acquiring company prior to the reorganization. In general, such stock would be added to the stock received by the old shareholders for purposes of the 40 percent test. But stock held by the acquiring corporation would not be included if acquired in a transaction covered by section 382(a) within a period of 36 months ending on the date of the exchange. Sections 382(b)(5) (A) and (B) might be simplified to read as follows:

"(A) Reorganizations in which not all stock of the loss corporation is exchanged. In computing percentages under subparagraphs (1)(B) and (2), the value of stock [and participating stocks] not exchanged (valued on the same basis as the stock exchanged) shall be combined with the value of the stock [and participating stock] received by the shareholders of the loss corporation in the reorganization, except to the extent such stock [or participating stock] was acquired by the acquiring corporation within 36 calendar months prior to the exchange in a transaction described in paragraph (a)(1) and not excepted by paragraph (a)(5)."

F. Practical difficulties in determining ownership

New section 382(a) requires that a corporation determine both the actual and the constructive ownership of its shares.[36] New section 382(b) does not require this determination, since for the most part, a determination can be based on the number of new shares issued in the reorganization involved. The committee, however, has suggested that the ownership concepts of sections 382(a) and 382(b) should be similar.

For closely-held corporations, determinations of actual or constructive ownership, while possibly complex, involve facts that are known or can be determined. However, a large proportion of the shares of many public corporations is held in street name, and the corporation's records do not indicate the actual ownership of shares, much less constructive ownership. In the committee's experience, it is very difficult, if not impossible, to obtain accurate information in such cases.[37] For example, brokerage houses and trust companies frequently will not disclose for whom they hold stock. We therefore suggest that a corporation should be able to rely on record ownership when it does not know and has no reason to know the actual ownership of its shares.[38] Alternatively, a corporation whose stock is publicly traded might be authorized to ignore any change in ownership not of record and of which it does not

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[34] *See* Association Statement, supra note 3, at 7.

[35] General Explanation, supra note 2, at 200–01.

[36] I.R.C. § 382(a)(4)(C).

[37] The problem is made more acute by the increase from 10 to 15 in the number of "largest" shareholders whose increases in ownership are taken into account. *Compare* I.R.C. § 382(a)(4)(B) (1976) *with* I.R.C. § 382(a)(2) (1954).

[38] *See* Reg. § 1.852-6(b), (c) (using similar approach in determining ownership of regulated investment companies); Reg. §§ 1.857-6(b), (c), (d) (real estate investment trusts).

have actual knowledge that change has not been reported pursuant to section 13(d) of the Securities and Exchange Act of 1934 [39] or similar provisions.[40]

IV. CONCLUSIONS

1. The committee believes that while there were problems and anomalies inherent in section 382 as it existed before the Tax Reform Act of 1976, no compelling evidence or reasons have been propounded for its replacement by a provision of such increased length and complexity, notwithstanding the increase in the carryover period for net operating losses to seven years.

2. Since section 382 limits the ability to utilize losses and other tax benefits only in those limited circumstances in which a taxpayer does not have other offsetting income, and since the objectionable windfall element of trafficking in loss carryovers and other tax benefits arises primarily from doubts as to availability of such carryovers, we believe that fresh consideration should be given to whether it is necessary or desirable to limit the transfer of such carryovers.

3. If it is concluded that limitations on the transfer of carryovers are required and that existing section 382 is inadequate, our principal recommendations would be:

(a) The steps taken in the Tax Reform Act to make sections 382(a) and 382(b) more parallel are a start in the right direction, but further progress should be made. In particular, the effects of these two provisions on multi-tiered corporate structures should be the same, and the exceptions contained in new section 382(a)(5), particularly with respect to transfers within attribution groups, should be made applicable to section 382(b). Consideration should be given to combining sections 382 (a) and (b) into a single test along the lines of the draft contained in Appendix A. Furthermore, the exceptions of section 382(a)(5) should be incorporated into section 269(b).

(b) Section 382 should not apply to limit the use of carryovers of a specific business against tax liabilities generated by that same business, provided that a taxpayer meets a strict burden of proof if it wishes to take advantage of this exception.

(c) The statute can and should be simplified substantially, even at the cost of some loss of precision. The 3½-1½ percent non-linear reduction is an example of an unnecessary complication. The dual definition of "stock" and "participating stock" promises to create difficulties in interpretation out of all proportion to its usefulness. The text makes a number of other suggestions for simplification.

(d) Any amendments dealing with carryovers should be a part of an overall effort to rationalize the various tax provisions which apply in the area. The attempt to deal with section 269 in the legislative history is unsatisfactory, both because it is non-statutory and also because its meaning is unclear. Built-in losses should be dealt with by statute, but only in cases where the potential for abuse is substantial. The present provisions of the consolidated return regulations concerning carryovers and built-in losses bear no relation to section 382 as amended, are susceptible to manipulation, and could be largely eliminated if the other recommendations made in this and the preceding paragraphs are accepted.

(e) Further consideration should be given to the problems of determining changes of ownership of stock of publicly-held corporations.

APPENDIX A

SECTION 382 SPECIAL LIMITATIONS ON NET OPERATING AND BUILT-IN LOSSES

(a) *Loss of deduction.*—If there is a change of more than 60 percent in the ownership of stock of a corporation (or a successor corporation to which section 381 applies) during a taxable year other than its first taxable year, then, except as provided in subsection (g), any net operating loss carryovers and any built-in loss from such taxable year and prior taxable years shall be reduced by 2½ percent for each percentage point by which such change exceeds 60 percent.

(b) *Change in ownership.*—A change in stock ownership shall be measured by subtracting (i) the percentage of the total fair market value of the stock owned at the beginning of the taxable year by each person whose percentage has increased by

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[39] 15 U.S.C. § 78m(d) (1970). Section 13(d) provides that any person (or group of persons) acquiring a 5 percent interest in any class of a corporation's equity securities, or increasing an existing 5 percent interest, must report such ownership to both the issuer of the security and the Securities and Exchange Commission.

[40] Additional reporting requirements would be imposed under both the proposed addition of section 13(g) to the Securities and Exchange Act of 1934, S. 305, 95th Cong., 1st Sess. § 203, 123 CONG. REC. S7193-94 (daily ed. May 5, 1977), and the amendment to Rule 17a-3(a)(9) under that act proposed by the Securities and Exchange Commission, 41 Fed. Reg. 8075 (Feb. 24, 1976) (brief proposal), 42 Fed. Reg. 3312 (Jan. 18, 1977) (extensive analysis) (to be codified in 17 C.F.R. § 240).

the end of the taxable year, from (ii) the percentage of the total fair market value of the stock owned by each such person at the end of the taxable year, except that changes arising from, and stock issued pursuant to, the following transactions shall not be taken into account.

(1) transfers of shares between persons who are each actual or constructive owners of such shares;

(2) transfers by gift, will, or the laws of descent and distribution;

(3) transfers to creditors in exchange for relinquishment of a claim, provided the claim was acquired in the course of acting as a lender or creditor and not for the purpose of acquiring the stock;

(4) transfers to a person continuously employed by the corporation prior to the transfer for the lesser of 36 months or the period of the corporation's existence;

(5) transfers to a trust described in section 401(a) exempt from tax under section 501(a) or to an employee stock ownership plan described in section 301(d) of the Tax Reduction Act of 1975, provided that such trust or plan is primarily for the benefit of employees of the corporation or of a controlled group of corporations (within the meaning of section 1563(a) determined without regard to section 1563(a)(4) and (e)(3)(C)) which includes such corporation: and

(6) redemptions described in section 303.

(c) *Constructive ownership.*—Section 318 (relating to constructive ownership) shall apply in determining the ownership of stock, except that sections 318(a)(2)(C) and (3)(C) shall be applied without regard to the 50 percent limitation therein, and except that a corporation may rely on record ownership unless the facts and circumstances are such that any director, officer, or owner of 5 percent of the value of the stock knows, or has reason to know, the actual identity of the owners of such shares.

(d) *Changes pursuant to a plan.*—Changes in ownership commencing in one or more prior taxable years which the Commissioner establishes are pursuant to a single plan, whether formal or informal, to circumvent the limitations of this section by lengthening a period of change of ownership shall be aggregated in determining the change in ownership for the taxable year.

(e) "*Stock.*" The term "stock" means all stock, except that which—

(1) is fixed and preferred as to dividends and does not participate in corporate growth to any significant extent.

(2) has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par value), and,

(3) is not convertible into another class of stock.

The Secretary shall prescribe regulations under which, by reason of conversion and call rights, rights in earnings and assets, priorities and preferences as to distributions or earnings or assets and similar factors, stock, warrants or convertible securities shall be treated as stock, or stock (however defined) shall not be treated as stock.

(f) *Built-In Loss.*—[Insert definition based on consolidated return regulations, but limited to cases where basis of all assets acquired is at least 50 percent higher than consideration attributable thereto.]

(g) *Exception.*—The limitations of this section shall not apply to the extent that the taxpayer demonstrates, pursuant to regulations prescribed by the Secretary and by clear and convincing evidence, that an operating loss or a built-in loss is applied to the taxable income from continuing trade or business which generated such loss.

The provisions of the consolidated return regulations limiting losses following the acquisition by a new common parent, a reverse acquisition and a CRCO would be withdrawn.

Chairman STARK. Thank you, Mr. Markizon. Without objection, your entire statement will appear in the record as it was presented to the committee.

I think, if you were present when Secretary Chapoton testified, he indicated that they do intend to ask for a 2-year extension, and I believe the American Bar Association concurs in that. And I suspect, it is my feeling that that is a reasonable estimate, and I imagine the committee would be disposed to grant that extension at his request.

When he was about to be sentenced, he said, "Your Honor, with God as my judge, I am innocent."

The judge said, "He ain't; I am. You aren't; 30 days." I have not heard such brevity since then.

I also agree, it seems to me that the financing business has changed and, obviously Dial Corp., in its operations, could be concluded to be nothing other than a finance company. And it seems to me, while we often feel that legislation is directed at one particular company, we try to avoid that. Times have changed and the laws have not. You did in your testimony, I believe, or my staff alluded to the fact there was some possibility that Dial may be acquired. You may not want to comment on this for a variety of reasons. But if there was a change in ownership in the Dial Corp. would that make this question moot? I presume that has not happened, is that correct?

Mr. RIDDELL. Were the announced plans of Dial and Northwest Bancorp to be completed, that would be true in their case. However, once before a similar move had been made, and permission for merger was denied by the Federal Reserve Board. We certainly don't expect it to be denied in this instance, but without regard to Dial, it is our information and belief that approximately 2,000 other finance companies in this country are very, very much in need of this legislation, and we would hope that the committee would proceed to enact this bill to take care of them as well. This represents the fourth time that an amendment of this kind has been necessary by virtue of changing conditions in the business. To that end, we hope that the committee will proceed.

Chairman STARK. I was not aware it was that often. You perhaps heard my inquiry of Secretary Chapoton as to whether there might be a better way to do this. He seemed to think not. I guess you would have to look at each State's laws. I hate to sit here and define what is a finance company and what is not, because they change with what happens. But perhaps we should say this seems to solve the problem for you, and there seems to be no objection to the bill. We perhaps ought to follow the adage "If it ain't broke, don't fix it," and proceed as quickly as we can with the bill as it is introduced.

Mr. RIDDELL. Thank you.

Chairman STARK. Mr. Duncan?

Mr. DUNCAN. I have no questions.

Chairman STARK. Mr. Heftel?

Mr. HEFTEL. No questions.

Chairman STARK. Thank you very much.

Our next witness is Mr. Thomas B. Harbison, the president of Harbison Ford.

STATEMENT OF HON. RICHARD T. SCHULZE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. SCHULZE. Could I make a brief statement?

Mr. Chairman, this issue has been before the full committee during our deliberations of the recently enacted Tax Act. It was decided at that time to put it off as a separate issue. It is a relatively small issue, but one of great importance to Mr. Harbison, who is a bus/automobile dealer from Pennsylvania.

We appreciate your taking the time to come here, and I hope as the discussion of the new regulations evolve you will keep us informed of how they affect your business.

Mr. Duncan.

Mr. DUNCAN. I have no questions. Thank you.

Chairman STARK. Mr. Heftel?

Mr. HEFTEL. I have no questions. But I do applaud you for your concise and accurate testimony. I want to make sure we acknowledge the fact that the administration just created, in its new leasing rules, an industry that had not existed before where you would deliberately incur and benefit from this type of loss, and certainly then we should extend a comparable degree of relief to those who inadvertently and with no malice aforethought proceeded to lose money and are entitled to some form of relief in that case.

Under whatever equity represents, we will hopefully change the law so that it does accommodate those who lost money.

That probably would also be in order, Mr. Chairman. Thank you.

Chairman STARK. Mr. Schulze?

Mr. SCHULZE. I have no questions.

Chairman STARK. Mr. Moore?

Mr. MOORE. Thank you, Mr. Chairman. I don't have any questions. But I am wondering when these complex technical problems are going to be worked out. We have been fooling around with them since 1977, and I wonder why it is every 2 years we keep automatically deferring this thing. Maybe it is a problem with the original action taken in 1976. The recently enacted tax bill seems to reverse an awful lot of the things that occurred in 1976. I would ask the subcommittee chairman to confer, maybe, with committee staff and the administration to look into the possibility of addressing the basic issues.

Chairman STARK. If the gentleman would yield, I would submit that the tax staff of this committee had that as one of the priority items on their agenda, except that a tax bill was sent to us, as the gentleman will recall, earlier in the year, which consumed most of our staff's time.

And his point is well taken. It is something that we should have addressed. We got sidetracked, and I suspect they did, too, but it was one of the things we wished to look at. Hopefully, we will get it completed.

Thank you very much.

The next witness is Mr. Lloyd Rich. He is a member of the board of directors of the Association of Media Producers and president of Prentice Hall Media, Inc.

Mr. Rich, without objection your entire statement will appear in the record as submitted to the committee, and you may proceed.

STATEMENT OF LLOYD RICH, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF MEDIA PRODUCERS, AND PRESIDENT, PRENTICE HALL MEDIA, INC.; ACCOMPANIED BY ROBERT A. WARDEN, ESQ., PEABODY, RIVLIN, LAMBERT & MEYERS; WALTER J. BEMBENISTA, DIRECTOR OF TAXATION, ESQUIRE, INC.; ANNE CULLATHER, DIRECTOR OF GOVERNMENT RELATIONS, ASSOCIATION OF MEDIA PRODUCERS

Mr. RICH. Thank you, Mr. Chairman. Mr. Chairman, members of the subcommittee, my name is Lloyd Rich. I am president of Prentice Hall Media, Inc. and have served as vice chairman of the board of directors of the Association of Media Producers, the national trade association representing the producers and distributors of educational media on whose behalf I am appearing today. With me this morning is Mr. Walter Bembenista, director of tax matters for Esquire, Inc.; Mr. Robert Warden, Esq., and Ms. Anne Cullather, director of government relations for the Association of Media Producers.

I am testifying in support of H.R. 2295, a bill to expressly allow the investment tax credit for educational filmstrips.

In 1976, when Congress enacted legislation allowing the investment tax credit for entertainment and educational films, the statute provided that the credit was to be available for "any motion picture film or video tape created primarily for use as public entertainment or for educational purposes."

The legislative history of that provision made clear that, at least insofar as educational films were concerned, Congress was concerned with "films used in primary and secondary schools, colleges and universities, vocational and post-secondary institutions, public libraries and government agencies."

Notwithstanding this legislative history, the Internal Revenue Service has taken the position that educational filmstrips do not qualify for the credit, apparently on the technical ground that filmstrips are not viewed by the Internal Revenue Service as "motion" picture films.

Filmstrips and similar media differ from motion picture films in only one respect. Motion picture films move across a screen; filmstrips and similar media are basically a series of individual frames which are organized and shown one at a time in sequence.

Educational filmstrips are virtually identical with educational movies and video tapes in terms of their educational content. In fact, a recent edition of Educational Marketer indicates that Westport Video, Inc. has developed a technique for converting educational filmstrips into video tape. Under the current Internal Revenue Service position, as we understand it, a producer who allowed his master negative to be used for producing video tape as well as filmstrips would be entitled to the credit, whereas the producer would not receive the credit if the master negative produces only filmstrips.

Educational filmstrips are a superior teaching tool and can be tailored to specialized needs such as the handicapped child. Filmstrips are also well suited for teaching the basic learning skills of reading, writing, grammar and mathematics.

Some recent filmstrips include: Working with Handicapped Children, A Special Need, A Special Love; Child Development and

Child Health; The Minority Child, With Pride and Progress; Write It Right; Words, Media and You; The Periodic Table of the Elements; and Mathematics for Beginners.

As we all know, in the current period of budgetary restraint, both at the Federal and State levels, many local school districts have moderate to severe budgetary problems. Obtaining the investment tax for filmstrips will help to insure that this valuable teaching tool remains available at a reasonable price.

For all of these reasons, we urge the enactment of H.R. 2295. We thank the committee for the opportunity to present these views.

[The prepared statement follows:]

STATEMENT OF LLOYD RICH, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF MEDIA PRODUCERS

SUMMARY OF PRINCIPAL POINTS

1. The legislative history of the Tax Reform Act of 1976 indicates that Congress voted to extend the investment tax credit to "any motion picture film or video tape created primarily for us as public entertainment or for educational purposes." The term educational films was further explained in the legislative history to mean "films used in primary or secondary schools, colleges and universities, vocational and post-secondary institutions, public libraries and government agencies."

2. Nothwithstanding this legislative history, the current position of the IRS is that filmstrips are not eligible for the investment tax credit, apparently on the technical ground that filmstrips are not "motion" picture films.

3. Filmstrips differ from motion picture films in only one respect. Motion picture films move across a screen; filmstrips are basically a series of individual frames which are organized and shown one at a time in sequence. In fact, under recently developed technology, it may now be possible to convert filmstrips to video tape; the same master negative may be used for both purposes.

4. For certain purposes, educational filmstrips are superior to motion pictures as a teaching tool. Filmstrips are useful in teaching the basic skills of reading, writing, grammar and mathematics. Examples of the type and variety of filmstrips which have been produced in recent years include: Working with Handicapped Children, A Special Need, A Special Love; Child Development and Child Health; The Minority Child, With Pride and Progress; Write is Right; Words, Media and You; The Periodic Table of the Elements; Mathematics for Beginners.

5. Filmstrips are generally sold at the local level. Many local school districts are facing budgetary cutbacks varying from moderate to severe. The investment tax credit is one device whereby producers may continue to make this educational tool available to local school districts at a reasonable cost.

STATEMENT

Mr. Chairman, Members of the Subcommittee. My name is Lloyd Rich. I am President of Prentice Hall Media, Inc. and have served as Vice President on the Board of Directors of the Association of Media Producers, the national trade association representing the producers and distributors of educational media materials. Educational media includes motion pictures, filmstrips, film loops, and video programs, among other materials produced for the education marketplace. My own company has been in the business of developing educational materials for many years and has worked closely with the Association of Media Producers over the past six years in the development of legislation to qualify educational film materials for the investment tax credit under Section 48(k) of the Internal Revenue Code of 1954.

I appreciate this opportunity to testify before your Subcommittee in support of H.R. 2295, a bill that will correct a technical error in the interpretation of the Tax Reform Act of 1976 and clarify that filmstrips are eligible for the investment tax credit as provided under Section 48(k).

AMP believes that corrective legislation is warranted and should be passed promptly for several reasons:

(1) To bring IRS regulations in line with the legislative history and original intent of Congress to provide the tax credit for educational film materials;

(2) To ensure that the law reflects accurately the similar development processes and tax treatments involved with educational materials;

(3) To ensure that an already small and financially suffering industry does not suffer further financial dislocation and reductions in employment;

(4) To ensure that schools, already facing severe budgetary restraints, are not confronted with a severe reduction in the availability of essential materials.

I. THE LEGISLATIVE HISTORY OF SECTION 48(k) SUPPORTS THE PROPOSITION THAT FILMSTRIPS SHOULD QUALIFY FOR THE INVESTMENT TAX CREDIT

Courts have long held that film, including educational film, has qualified for the investment tax credit master film negatives are to be treated as tangible personal property: because the Congress recognized these court rulings when it passed the Revenue Act of 1971.

During the consideration of the Tax Reform Act of 1976, the House inadvertently omitted educational films as being within the definition of "qualified film". The error, however, was corrected in the Senate and the final bill was passed providing that any "qualified film" is eligible for the investment tax credit. The term "qualified film" is defined as "any motion picture film or video tape created primarily for use as public entertainment or for *educational purposes*" (Emphasis added.) (Public Law 94-455, sec. 804.)

The application of the credit to "educational films" was further clarified in the legislative history through the following report language accompanying bill: "The credit is to be available only for 'qualified films,' i.e., motion picture films or television films or tapes created primarily for use as public entertainment, and educational films, i.e., generally films used in primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries and government agencies." (Senate Report 94-938, 94th Cong. 2d sess., p. 186.)

This report language makes clear that educational films were not defined by their format but rather by the use to which these films were put—educational institutions, libraries and government agencies.

When the Internal Revenue Service issued proposed regulatory guidelines on December 20, 1977, the regulations were silent with respect to filmstrips for educational purposes. AMP and Congressman Ottinger responded to the proposed regulations and advised the IRS of their oversight, requesting a clarification. Final regulations were finally published on April 5, 1979 but again were silent with respect to filmstrips.

On May 9, 1979 Senator Bentsen introduced S. 1102 which would remedy the situation and amend the definition of a qualified film expressly to include educational filmstrips, as does the legislation we are considering (H.R. 2295). In his remarks, Senator Bentsen explained that his bill was simply intended to carry out the original intent of Congress in enacting the investment tax credit for educational films.

"During consideration of the 1976 Tax Reform Act, the House of Representatives inadvertently excluded educational film materials from eligibility for the investment tax credit. During Senate Finance Committee consideration of that legislation, I offered an amendment to correct this oversight and restore the eligibility of educational film materials for the investment tax credit. This amendment was adopted by the Finance Committee without objection and included in the final version of the Tax Reform Act of 1976.

"Unfortunately, recent regulations issued by the Internal Revenue Service with respect to the investment tax credit appear to exclude education filmstrips from eligibility for the credit. This was not the intent of Congress." (123 Congressional Record S. 5596.)

Notwithstanding this clarification, and despite the fact that the regulations were silent in this area, on November 6, 1979 the Internal Revenue Service issued Manual Supplement 45G-321, which stated: "In general, a qualified film is a motion picture or video tape (*not filmstrips*) used for public entertainment or educational purposes." (Emphasis added.)

Insofar as we have been able to determine, apparently this action was taken on the technical ground that, in the opinion of the IRS, filmstrips were not "motion" picture films.

It appears to AMP members, many of whom relied upon the legislative history and apparent intent of Congress that all educational films would secure tax credit, that the IRS position is a highly technical reading of the statute which pays little heed to Congressional intent. A close examination of the legislative history would reveal that filmstrips should qualify for the investment tax credit on the same basis as motion picture films.

II. THE LAW SHOULD REFLECT THE FACT THAT ESSENTIALLY THE SAME PROCESS IS INVOLVED IN PRODUCING BOTH EDUCATIONAL MOTION PICTURE FILMS AND EDUCATIONAL FILMSTRIPS

Filmstrips differ from motion picture films in only one respect. Motion picture films move across a screen; filmstrips are basically a series of individual frames which are organized and shown one at a time in sequence.

Beyond the legislative intent, AMP believes that the IRS definition of films or tapes should, in and of itself, qualify educational filmstrips for the credit. In fact the regulations specify: "A film strip is a single asset consisting of three elements: the artistic dramatic creation, the physical films and tapes (including the original negative or tape and duplicate negatives, release prints or tapes, and original sound recording and all other sound recording created to simultaneously accompany the pictorial materials) which embody the artistic dramatic creation, and the world-wide copyright . . ."

We would like to point out that educational 16mm film, video tape and filmstrips all conform to the above definition. All prints are made from the master negative, and it is the master negative which constitutes the tangible personal property under section 38 of the tax code. It is the master negative which is therefore eligible for the tax credit regardless of the "format", i.e., motion picture, filmstrip, etc.—all come from a master nagative. The credit was given to educational films, and it was understood, as noted in the Senate report language, that it would include all educational film materials as defined by its use—not by its particular format.

We cannot emphasize enough that the master negative is the key, and with very good reason: in terms of the creative process, the physical production, the utilization and the distribution, these are all the same medium. The process for the creation of the "intellectual" component is identical in all cases regardless of format: writers develop scripts under the supervision of editors; directors and producers hire cameramen, audition actors and select shooting locations. After filming, studio work is completed and the film is ready for production.

With respect to the production process, the raw film stock is the same in all cases, as is the chemical process for developing the film; the photographic process is the same, and the master negative used for the printing of multiple copies is the same. All are designed for the same educational audience, and any distinction based upon movement or the lack thereof is without practical validity. Movies and television depend to a great degree on the reproduction of still images, and the montage of still images in slides can replicate motion. "Motion" pictures, are, after all, nothing more than a very rapid projection of a series of still images.

In fact, the September 1, 1981 edition of Educational Marketer indicates that a company known as Westport Video, Inc. has now developed a process which would make it possible to convert filmstrip material to video tape. Under the current IRS approach, as we understand it, a producer would not be eligible for the investment tax credit if his master negative was used solely to produce filmstrips, but presumably would be eligible if he elected to also make video tape, since video tape is expressly covered in the statute.

Finally, with respect to distribution, the Federal government regards all of these media as the same for purposes of postal classification; Federal, state and local government all classify them as one for purposes of school and library purchasing; professional organizations regard motion pictures and sound filmstrip the same for purposes of evaluation, review and the awarding of prizes for excellence; and finally, AMP, in all the materials presented to Congress during the consideration of the Tax Reform Act of 1976, combined all the various formats under the heading "educational film materials" so as to precisely indicate the broader application of the law. This description served as the basis for the inclusion of all such materials in the Tax Reform Act of 1976, now under discussion.

For tax purposes as well, it can be shown that producers of filmstrips generally provide the same tax accounting treatment to both films and filmstrips; expenses of producing the master negative are generally capitalized; the useful life varies from 3 years to 10 years, but in most instances is the same between films and filmstrips; and the method of depreciation is generally the same.

There is, therefore, no logical, rational reason for making any distinction between the formats with regard to eligibility for the investment tax credit.

III. CORRECTIVE LEGISLATION IS NEEDED TO INSURE THAT AN ALREADY SMALL AND FINANCIALLY SUFFERING INDUSTRY DOES NOT SUFFER FURTHER

AMP would like to point out to Congress that the industry affected by this rather minor piece of legislation is by no means large—in fact, with very few exceptions, all of our member companies can conform to the definition of "small business" as

set forth by the U.S. Small Business Administration. The revenue effect of this bill will be minimal, but the revenue which is involved is critical to such a small industry.

The industry 1980 sales report for the year ending December, 1980 demonstrated industry sales totalling $260 million for 16mm film videotape and other materials; that is a 1 percent growth over 1979 and a very real decline when inflation is taken into account. To put that in perspective, this industry's total sales is about 50 percent of what the U.S. Federal government alone spends on audiovisual activity in one year. By any standards, that is small business. About 30 percent of the market can be attributed to filmstrip sales.

A profile of the industry would show very small companies with annual sales of less than $1 million. Because of their small size, it is harder for them to secure capital for their investment since credit is harder to obtain. The costs of producing educational media have risen rapidly over the past few years, and the continued escalation of these costs has created serious problems for both producers and school purchasers. Quite obviously, the unavailability of the investment credit would drastically affect most educational producers; some would go out of business, and others would be forced to drastically cut back production and increase prices. In these instances, there would be a decline in employment, since there would be a reduction in new product development and therefore less demand for researchers, scriptwriters, filmmakers, etc. AMP believes that the IRS regulations, excluding filmstrips from eligibility for the tax credits directly contradicts the primary purpose of the investment credit to create jobs and thereby stimulate the economy.

Furthermore, it should be pointed out to Congress that the investment in education film, filmstrips and videotapes is a high risk decision. It may take several years to develop a film from the planning stages to the actual filming and marketing. They are not pre-sold (in most cases educational films are sold on approval), and they require vigorous advertising, promotion and marketing programs to return the investor's full capital. Moreover, because of the nature of the school market, there is a forced delay on investment returns from two to four years. Generally, it will take at least seven years for an educational film to return approximately 95 percent of its revenue potential. With such a delayed return on investment, many producers could not afford to continue if the investment tax credits were eliminated.

IV. CORRECTIVE LEGISLATION IS NEEDED TO INSURE THAT SCHOOLS, ALREADY FACING SEVERE BUDGET CUTS, ARE NOT CONFRONTED WITH A SUBSTANTIAL REDUCTION IN THE AVAILABILITY OF MATERIALS OR WITH SHARPLY INCREASED PRICES

The negative impact that loss of the investment tax credit will have on the schools of this nation should not be underestimated. Educational media materials have long been an integral part of the curriculum, and have proved to be a cost-effective, learning-efficient tool for quality education. Loss of the investment tax credit for these educational audiovisual materials could result in decreased production and/or increased prices since few, if any, of the companies could afford to absorb such a loss. Regardless of whether it is production that is decreased or prices that are increased, the result is the same: the availability of educational audiovisual materials essential to quality education programs will be seriously diminished.

The fiscal problems plaguing local school districts and other educational institutions are well-known. It has only been compounded by the severe budget cuts we are withnessing at the state level and the erosion of important federal support. It is hard enough for schools to acquire the essential materials, they need, facing such funding cuts are routine price increases caused by inflation, without having to confront added costs which would result here.

Industry sales data indicates that during recent years when school materials budgets have been slim, sales of filmstrips have been increasing. One of the reasons they have become so popular is that they are less expensive to purchase than many other forms of instructional materials. If Congress allows the current situation to go uncorrected, it will deprive school districts of one of the most effective, inexpensive forms of instructional assistance available to teachers.

For these reasons, we hope that the Congress will not delay in passing H.R. 2295 to clarify that educational filmstrips are eligible for the investment tax credit.

Chairman STARK. Thank you, Mr. Rich. I ought to preface my inquiry by saying I am one of the people for a long time who have opposed the investment tax credit on the theory that it is unfair. Your company illustrates it is unfair. Why should somebody who is going to build an oil refinery get an investment tax credit and

somebody who is going to invest in very intangible sorts of things not?

I would ask if you would do this, either for the record or off the record, for my edification. But we had suggested, and it has been suggested that if we eliminate the investment tax credit, then we could, therefore, with the same money that the Treasury would get reduce your corporate rate from, well, the last time we suggested we reduce 46 percent to 34 percent. I have asked several companies to tell me, would that not, if they went over the past 3 years or, in your case, if you wanted to project it, go back over the last 3 years and calculate what might have happened if over the past 3 years you had had the investment tax credit you request or had a maximum corporate rate of 34 percent, and I suspect you would have paid fewer taxes under the 34 percent rule than you would with the credit—well, maybe not.

I ask that, because I start from the premise, as Secretary Chapoton said this morning, we probably should not have any investment tax credit. Its original concept has long since fallen through the cracks. It is one of those incentives that is no longer an incentive, and it creates a lot of problems that are unfair.

I am constrained to share the Secretary's feeling that if we do anything, we should tighten it up, and it is not for any negative feelings I have about filmstrips. I am afraid of what the next step down the line is, in that there is really no tomorrow in granting investment tax credits when you stray from the original concept.

Mr. MOORE. I agree with the chairman completely, and will inform the chair, if this particular bill is brought before the committee, I intend to offer amendments that will do precisely that. That will not liberalize further the rule in this area, but quite to the contrary, strike the investment tax credit in this area.

Chairman STARK. As I say, subsequently, if you would accommodate me in terms of how this change would affect your own financial fortunes, it would be of interest to the chair.

Mr. Duncan?

Mr. DUNCAN. I have no questions. Thank you.

Chairman STARK. Mr. Schulze?

Mr. SCHULZE. No questions.

Chairman STARK. Mr. Moore, do you want to inquire?

Mr. MOORE. No.

Chairman STARK. I appreciate your taking the time to present your testimony. And as I say, I assure you that I do think that your industry is one that is to be commended for aiding education in an area toward which we devote all too few resources. But in the context of the Tax Code, it is just one more step in adding a whole host of new deductions and credits, and I would hope that we could provide financial incentives to your industry and all others who do not now enjoy the investment tax credit in some other way.

Thank you for taking the time to testify.

[The following was subsequently received:]

PRENTICE HALL MEDIA,
TARRYTOWN, N.Y., *October 28, 1981.*

Hon. FORTNEY H. STARK
Chairman, Select Revenues Subcommittee,
House Ways and Means Committee,
Washington, D.C.

DEAR CONGRESSMAN STARK: As a followup to my oral testimony of October 19, 1981 I am requesting that the following be added to the record in support of H.R. 2295, a bill to expressly allow the investment tax credit for educational filmstrips.

My response to your question concerning the relationship of the investment tax credit and the lowering of the federal tax rate is as follows:

If the Select Revenues Subcommittee could lower the federal tax rate to 34 percent in lieu of the investment tax credit this would be beneficial to my company. Prentice-Hall Media, however, is not really representative of the industry since we are a subsidiary of a larger publishing company. If however, we were a separate company the investment tax credit would be more beneficial than a lowering of the federal tax rate. Many companies in our industry would not be helped by the lowering of the tax rate since they are small companies who often make only marginal profits. In their case the investment tax credit would be more beneficial.

Today the question is not whether we sometime in the future will have a lower tax rate but whether or not our industry should receive the investment tax credit for educational films.

Legislative history clearly demonstrates that Congress was concerned with educational films that were to be used in primary and secondary schools, colleges and universities, vocational and post-secondary institutions, public libraries and government agencies. Despite this history the Internal Revenue Service has taken the position that educational filmstrips are not educational films. This at least is an extremely unjustified and arbitrary ruling since filmstrips differ from motion picture films and videotapes in only one respect; motion picture films move across a screen while filmstrips are basically a series of individual frames which are shown one at a time in sequence. The educational content of educational movies and videotape is virtually identical with that in educational filmstrips.

A further irony of the Internal Revenue Service ruling is that recent technological advances now provide techniques for converting educational filmstrips into videotapes.

The Select Revenues Subcommittee now has before it H.R. 2295 which would expressly allow the intent of Congress to be implemented in that all educational films, whether they be educational movies, videotapes or filmstrips, would be eligible for the Investment Tax Credit.

Sincerely,

LLOYD L. RICH, *President.*

Chairman STARK. James W. Riddell is the counsel for the Dial Corp. Mr. Riddell, we have your statement, and without objection it will appear in the record in its entirety. And I would ask you to proceed to summarize your statement in any way you see fit. Welcome to the committee.

STATEMENT OF JAMES W. RIDDELL, ESQ., MEMBER, DAWSON, RIDDELL, FOX, HOLROYD & WILSON, COUNSEL, ON BEHALF OF DIAL CORP., ACCOMPANIED BY DICK HOLROYD, ESQ.

Mr. RIDDELL. Thank you, Mr. Chairman. I thank you and the members of the committee for this opportunity to appear before you. I am accompanied by my partner, Dick Holroyd.

We agree completely with the statements, in summary, of Mr. Chapoton with respect to H.R. 2397. In order to save the time of the committee, I will be happy to lay myself open to questions at this time.

[The prepared statement follows:]

STATEMENT OF JAMES W. RIDDELL, ON BEHALF OF DIAL CORP.

Mr. Chairman, I am James W. Riddell, a member of the law firm of Dawson, Riddell, Fox, Holroyd and Wilson, Washington, D.C. and I am appearing today on behalf of Dial Corporation in support of H.R. 2397.

Dial Corporation, headquartered in Des Moines, Iowa, is predominately a consumer finance company extending credit in numerous forms both to consumers and commercial operations. This legislation will favorably affect Dial Corporation. However, this is not a one-company measure. It is estimated that some 2,000 companies, most of them small, have an interest in this measure. The 1980 Federal Reserve Survey recognized 1,749 companies with outstandings of under $1 million, and an additional 484 with outstandings of $1 million to $5 million. It is estimated that substantially all, if not all, are family owned or owned by a small number of investors which would or could be affected by the personal holding company provisions and would be benefited by updating the current exceptions.

H.R. 2397 updates the present Internal Revenue Code definition of a "personal holding company" as it relates to "personal holding company income" for lending and finance corporations. The personal holding company provisions, which have been in the Code for many years, are designed to tax "passive income" earned by certain closely-held corporations. The Congress, as well as the Treasury, had consistently recognized that those companies, even though closely held, which engage in the active conduct of the lending and finance business were not to be penalized by reason of the personal holding company provisions and, therefore, specific exceptions have been written into the law. Beginning in 1938, exceptions were created for the active conduct of the finance business. From time to time, as the method of operation of the industry has changed, Congress has updated these provisions of the Code to reflect the then-existing practice. Such action was taken in 1950, 1962 and 1964.

Currently, the form of operation and type of loan made by consumer finance companies is becoming more concentrated in "home equity loans" and "manufactured home" (mobile home) financing, generally having maturities of up to 12 years and in revolving credit, also known as open-end credit, which has no stated maturity. It is to accommodate these changes in loan maturities which now exist and will increase in the future that S. 644 seeks to amend existing law. This is not a new exception and will create no revenue loss. The provision merely updates present law and allows all companies in the industry to compete on an equal basis.

An identical bill (S. 2396) was introduced in the last Congress and was supported by the Treasury Department in testimony before this Subcommittee. That bill passed the Senate in the last Congress as a part of H.R. 7117. Regrettably, due to procedural problems, Congress adjourned before action could be taken in the House. Identical legislation, S. 644, has been introduced in the Senate by Senator Jepsen. The Subcommittee on Taxation and Debt Management of the Senate Finance Committee conducted a hearing on S. 644 on May 22, 1981.

PRESENT LAW

Present law imposes a tax of seventy percent on the undistributed income of a personal holding company (Sec. 541-547). A personal holding company is defined as a corporation, sixty percent (60 percent) of the adjusted ordinary gross income of which is personal holding company income (generally passive investment income), and fifty percent (50 percent) of the stock of which is owned by five or fewer persons. Certain types of companies whose active business involves the investment of funds and the earning of interest and dividends (i.e., normally passive income is income not from the active conduct of a business), are excluded from the personal holding company provisions.

Among the businesses excluded from the definition of a personal holding company are certain consumer finance companies (Sec. 542(c)(6)). Among the types of consumer finance companies intended to be excluded are licensed personal finance companies operating under the small loan (Russell Sage) laws of the various states, lending companies (not of the Russell Sage type) engaged in the consumer finance business, Morris plan banks, and finance companies engaged in the business of factoring inventories, accounts receivable, and otherwise financing the short-term and intermediate-term needs of business.

In order to meet the requirements for the finance and lending company exemption, a finance company, inter alia, must earn 60 percent or more of its income from loans which have an average maturity of less than 60 months. It is this 60-month maturity requirement which has failed to reflect the dynamic changes in the finance industry in recent years.

HISTORICAL BACKGROUND

While the tests to be met in order to enjoy the exclusion are the same, regardless of the type of finance company involved, this has not always been the case; and, it was as the result of Congressional attempts to simplify the various earlier exclusions that the present 60-month limitation inappropriately became a rule of general application.

The exception from the application of personal holding company rules to licensed personal finance companies was added to the Internal Revenue laws by the Revenue Act of 1938. The exception was added to grant exemption for companies operating in the various states under statutes similar to the Uniform Small Loan Act drafted by the Russell Sage Foundation. These statutes have typically been referred to as Russell Sage laws. Under these state laws, interest could not be payable in advance or compounded and could be computed only on unpaid balances. Furthermore, the laws limited the principal amount of the loan (usually to less than $500), the term (usually less than 3 years) and the amount of interest (usually less than 3 percent a month).

The provision contained in the tax law attempted to mirror these general state requirements, rather than being more strict, as a means of insuring that the exception generally reflected the active business practices which it was designed to except. As the result, when the circumstances of the consumer lending business have rendered the tax requirements more strict than state regulatory provisions, the tax provisions have been altered as well. The primary example of this reflection action is the change effected in the provision in 1962.[1]

Prior to 1962, the personal finance company exception mirrored the earlier restrictive provisions of Russell Sage laws. The conditions for exceptions under the law at that time required that a finance company must:

1. Be authorized to engage in the small loan business under one or more state statutes providing for the direct regulation of such business;
2. Derive 80 percent or more of their gross income from lawful interest, discount, or other authorized charges;
3. Derive the 80 percent of their income, referred to above, from loans maturing in not more than 36 months made to individuals in accordance with the provisions of applicable state law;
4. Derive this 80 percent of their income from loans where the interest and all other authorized charges do not exceed the amount equal to simple interest computed at the rate of 3 percent per month not payable in advance and only on unpaid balances;
5. Derive 60 percent of their gross income from lawful interest, discount, other lawful authorized charges received from individuals whose indebtedness to the company does not exceed the limit prescribed by the applicable state law, or, if there is no such limit, $500;
6. Have trade or business expenses deductions (other than compensation for personal services rendered by shareholders or members of their family) equal to 15 percent or more of their gross income);
7. Have outstanding loans with respect to any person who is a shareholder having a 10-percent interest in the stock of the company (including stock owned by members of the family) of not in excess of $5,000.

Recognizing that the requirements no longer reflected the then-existing State statutory limits, but were more strict, Congress, in the 1962 legislation, deleted the three percent interest requirement entirely, deleted entirely the 36-month loan limit, and increased the limit on maximum amounts for loans from $500 to $1,500. The legislative history of these changes as contained in the Report of the Senate Committee on Finance is instructive (in pertinent part):

"This bill omits this 3-percent-simple-interest requirement entirely, on the grounds that the personal holding company tax is not intended as a means of regulating the lending companies, but rather as a tax applicable in certain cases, to passive investments. In any event, this is an ineffectual regulatory device since this restriction applies only to about 10 percent of the outstanding small loans that are made by widely held finance companies, and therefore not treated as personal holding companies since they do not have five or fewer stockholders owning more

[1] It should be noted that in 1950, an exception was added to permit interest on business loans to be computed by the "dollar add on" method to reflect changes in the law of almost one-half of the states permitting such loans.

than 50 percent of their stock. Moreover, even the companies presently subject to this restriction need to meet it only with respect to 80 percent of their gross income.

* * * * * * *

"The bill also deletes the requirement that these lending companies derive most of their income from loans maturing in not more than 36 months. Several States already have gone beyond this as a permissive period for loans and it appears likely that in the near future a number of additional States may extend maturities to more than 36 months. Your committee agrees with the House committee that it should not impose a requirement substantially more restrictive in nature than the State laws regulating this type of lending company.

"A third change made by the House bill modifies the maximum size of a loan which may qualify under the 80-percent-income requirement where there is no State law governing the maximum size of a loan. Under present law where there is no such limit under State law, a limitation of $500 is provided. Under the bill this limitation is increased to $1,500. It is understood that the only State which does not have a ceiling of its own is the State of California. When the $500 limit provided by present law was considered, this represented the usual ceiling among the States. The States have changed these ceilings materially, however, with the result that today relatively few States have a ceiling of $500 or less and in these cases there usually is provision for supplementary loans which exceeds this ceiling in certain situations. The $1,500,000 provided by this bill, where there is no applicable State limitation, today is substantially in conformance with the ceilings applicable in those States providing their own maximums.

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"A fifth change relates to the use of the term, 'small loan business,' which represents the type of business in which a lending company must be engaged in order to be removed from application of the personal holding company tax under this exception. The bill adds after the term 'small loan businesses' the term '(consumer finance business)'. This is intended to make it clear that this exception is not limited to small loans in the narrow sense, but rather is intended to encompass consumer finance loans generally. Moreover, the reference to consumer finance business will bring this exception more directly in accord with the terminology now used by a number of State legislatures which have retitled the applicable provisions governing these institutions as 'consumer finance laws' as a means of providing a more descriptive title for the type of business involved." S. Rep. No. 2047, 87th Cong., 2d Sess.—(1962), reprinted in [1962] United States Code Cong. & Ad. News 2825, 2827-2828.

An equally compelling policy reason for eliminating tax requirements which are more restrictive then requirements of the various State laws was expressed by then-Assistant Secretary of the Treasury, Stanley Surrey, in his comments to the Senate Committee on the proposed revisions:

"It has been the Department's consistent position that taxpayers in like situations should be subject to the same rules and rates of taxation. The effectiveness of our self-assessing system to a large extent depends upon each taxpayer's willing compliance with laws which are regarded as rational and fair. Since [the small loan provisions] selects only a portion of the small loan industry for regulation, and since that portion is similar to other businesses not subject to these rules, the Department has no objection to the removal of the 3-percent-a-month and 36-month regulatory limits." S. Rep. No. 2047, 87th Cong., 2d Sess.—(1962), reprinted in [1962] United States Code Cong. & Ad. News 2825, 2830-31.

While the 1962 legislation vastly improved the equity of the tax treatment accorded closely-held finance companies, the provision, as amended, remained extremely complex. As the result, in the Revenue Act of 1964. Congress simplified the exception by imposing one set of standards upon all types of finance companies. In so doing, a limitation of the term of loans for consumer finance companies found its way back into the law.

Subsequent to the revisions made by the 1962 Act, there remained four different types of personal finance companies which were excluded from the personal holding company category:

1. Licensed personal finance companies, 80 percent of whose gross income is interest from loans if at least 60 percent of their gross income is received from loans classified as "small loans" by State law (or $500 if there is no State law limit) and if the interest is not payable in advance computed only on upaid balances. In addition, loans to a person who is a 10-percent shareholder must not exceed $5,000 in principal amount. These frequently are known as "Russell Sage" type personal finance companies.

2. Other lending companies engaged in the small loan or consumer finance business, 80 percent of whose gross income consists of interest or similar chargers on loans to individuals and income from 80-percent-owned subsidiaries which in turn themselves meet this test. In addition, at least 60 percent of the company's income must be from interest or similar charges made in accordance with small loan or consumer finance laws to individuals where the loans do not exceed the State specification for small loans (or if there is no such limit, $1,500) and if the trade or business expenses of the company represent 15 percent or more of the company's gross income. These companies also must not have loans outstanding to shareholders, with a 10-percent interest or more, which exceed $5,000.

3. A loan or investment company (such as Morris Plan bank), a substantial part of whose business consists of receiving funds not subject to check and evidenced by certificates of indebtness or investment, and making loans and discounts. Here also loans to a person who is a 10-percent shareholder may not exceed $5,000 in principal amounts.

4. A finance company actively engaged in purchasing or discounting accounts or notes receivable, or installment obligations, or in making loans secured by any of these or by tangible personal property, if at least 80 percent of its gross income is derived from such business. In addition, at least 60 percent of such a company's gross income must be derived from certain categories of income. These categories, in general, relate to business or factoring-type loans: such as purchasing or discounting accounts or notes receivable, or installment obligations arising out of the sale of goods or services by the borrower in his business; making loans for not more that 36 months to businesses where the amounts are secured by accounts or notes receivable or installment obligations of the type described above, or secured by warehouse receipts, bills of lading, inventories, chattle mortgages on property used in the borrower's trade or business, etc. In the case of these companies, the trade or business expenses deductions must represent at least 15 percent of the gross income of the company, and loans to those who are 10-percent shareholders in such company must not exceed $5,000 in principal amount.

It should be noted that the only type of finance company upon which a maturity limit was imposed was a finance company engaged in purchasing or discounting accounts or notes receivable, or installment obligations, or in making loans secured by any of these or by tangible property. Such factoring-type companies were required to earn at least 60 percent of their income from, inter alia, loans to businesses for not more than 36 months, where the loans arose out of the borrowers trade or business.

Curiously, when the Congress "simplified" the exceptions in the 1964 Act, the limit was written to have precisely the opposite effect. As the result of the 1964 Act, the 36-month limit was expanded to 60 months, but rather than applying to loans by factoring-type companies, the limit, now contained in Sec. 542(d)(1)(B)(i) was written to apply to all but such factoring-type loans.

It is important to note that if the word "unless" in Sec. 542(d)(1)(B)(i) were changed to the word "if," the new law would have accomplished the simplification result without resurrecting a limit previously deleted as too restrictive. That simplification was the intent of the 1964 changes and that the same policy underlying the deletion of the 36-month limit was to be retained is clearly reflected in the House Committee Report:

"In the interest of simplification, your committee concluded that it would be desirable to have one exclusion available for all four of these categories of lending or finance companies. At the same time, it saw no need for purposes of the personal holding company provision to restrict the type of loans which these companies could make. This is properly a matter of regulation by State law governing these lending or finance businesses. Moreover, it was recognized that in any event the personal holding provisions do not apply to widely held corporations. In such cases only State law governs the type of loans which can be made." H. Rep. No. 749, 88th Cong., 2d Sess. (1964), reprinted in [1964] United States Code Cong. & Ad. News 1313, 1389–1390.

In the absence of an explicit explanation in the legislative history of the inclusion of a 60-month limit, one might conclude that Congress merely painted with too broad a brush when it simplified prior law. However, in light of the total reversal of the type of company to which it was to be applied and the reiteration of the policy underlying the original deletion, it is far more plausible to conclude that the 60-month limitation of present laws does not reflect legislative policy, but rather inadvertent error.

REASONS FOR CHANGE

Whether the result of error or generalization, the 60-month limit needlessly restricts closely-held consumer finance companies from competing on an equal basis with more widely-held companies in rapidly expanding areas of consumer finance.

As previously stated, the limitation on the term of loans was deleted because the lending and maturity restrictions under most state laws had become far more liberal than the federal tax provision. That is even more the case today. Most consumer finance companies presently operate, not only under Small Loan loans, but also under generally applicable second mortgage, usury, industrial loan and similar laws. In almost all instances, the general usury law imposes no maximum maturity. This expansion beyond small loan laws has resulted from fundamental changes in the competitive structure of the entire finance industry. Rather than competing for small loans, the bulk of recent market expansion has been in the areas of revolving credit and second mortgage loans. In the case of revolving credit, the loans have no fixed maturity. In the case of second mortgage and manufactured home loans, probably owing to the size of the loan, the maturities typically equal or exceed 60-months. (Generally, up to 12 years (144 months)).

The trend in personal loans is definitiely toward longer maturities, and, in the case of the rapidly expanding revolving or open-end credit, no fixed maturity at all in the traditional sense. According to statistics developed by the Federal Reserve Board, the percentage of personal loans having a maturity of over 42 months increased from a negligible amount in 1972 to 26.4 percent of loans made in 1977. The 1977 figure almost doubles the percentage of higher maturity loans from the year before.

Additional data on consumer finance transactions compiled by the First National Bank of Chicago reflects that the percentage of loans written for longer than 37 months (the only category including over 60-month loans) grew from 11.76 percent in 1972 to 20.35 percent in 1977 to 30 percent in 1978.

This data reflects not only the increase in numbers of longer maturity loans but the rapidity with which the numbers of such loans are increasing. It may be expected that, particularly with the tremendous increase in the volume of second mortgage loans (almost all of which have maturities of at least 60 months or longer), the strength of the trend will continue.

H.R. 2397

H.R. 2397 will amend section 542 of the Internal Revenue Code in two respects. First, section 542(d)(1)(B)(i) will be amended by replacing the 60-month maturity limitation with a limitation of 144 months. Additionally, the bill will except from the computation of average maturities all open-end or revolving credit transactions (indeterminate credit) as that term is defined in the Truth in Lending Act.

The second amendment will tighten the eligibility rules for the consumer finance company exclusion from the definition of "personal holding company." Subsection (c) of section 542 excepts a number of business enterprises from the definition of a "personal holding company." Paragraph (6) of that subsection provides for the exclusion of certain lending or finance companies if certain conditions are met. Among those conditions is the requirement that the sum of deductions which are directly allocable to the finance business must exceed the sum of 15 percent of the first $500,000 of ordinary gross income from the finance business, plus 5 percent of the second $500,000 of gross income from the finance business.

At the request of the Joint Committee on Taxation, H.R. 2397 will extend the amount to which the 5 percent applies from $500,000 to the total amount of all gross income derived from the finance business which exceeds $500,000. The result will be that overall percentage of deductions directly attributable to gross income from the finance business must be greater than under present law in order for a consumer finance company to qualify for exclusion under the personal holding company provisions.

CONCLUSION

H.R. 2397, therefore, represents a balance between the need to accommodate a changing business environment and the need to insure that the exception is not employed as a device to avoid the personal holding company rules. We respectfully urge expeditious and favorable consideration of this legislation.

Chairman STARK. I thank you for your brevity. I am reminded of a judge in my district who was often complimented for his brevity, and it was illustrated by a criminal who was before him one day.

The issue was fairly well described by Mr. Chapoton, although there were some points which I might have emphasized a little bit more. In fact, this is almost a classic case of the Federal Government in all its power coming down and not really proscribing rules and regulations that a small businessman could comply with. However, be that as it may, what we are talking about is a matter of equity, and I think that most of us will agree that we should pass this measure.

The only point in contention that I see at this time is the matter of interest on this money that is due from the IRS. Rather than have that point, no matter how strongly I feel about it, become an issue which would cloud or impede the progress of this legislation, I will inform the Chair that I am prepared to drop that section of the measure which requires the payment of interest. This does not in any way negate my very strong feelings that in such instances the Federal Government does have some obligation to compensate those who have been kept from using their own resources for a period of time.

I would ask the chairman that my full statement be put in the record.

Chairman STARK. Without objection.

[The prepared statement follows:]

STATEMENT OF HON. RICHARD T. SCHULZE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. Chairman, H.R. 4408 is a bill that would extend to December 31, 1982 the deadline for rebate of federal excise taxes on the sale of certain buses. Let me stress that these are taxes that Congress has already agreed to refund. This bill is remedial in nature and intended to insure that administrative requirements of the original repealing act do not deny the purchasers of the buses their rightful refund.

When Congress passed the Windfall Profits Tax, it terminated the excise tax on certain buses. As part of this repeal, the statute provided that the IRS would pay out a refund of excise taxes already collected on buses sold between April 20, 1977 and the date of enactment.

Because Congress had bad experience with the automobile excise tax refund, the bus excise tax repealer established a procedure designed to guarantee that the purchaser of the buses, upon whom the real burden of the tax fell, would actually receive the tax refund. This was a laudable goal. However, the administrative requirements were difficult to comply with in the case of one small business which serves as the representative of the Prevost Bus Co. Mr. Thomas B. Harbison, of Harbison Ford, Inc., is here with us today and will describe for the committee his experience in trying to comply with the requirements of the law.

That law specified that the seller of the buses act as financial intermediary by first refunding to the customer the amount of the excise tax collected. Second, the seller could apply to the IRS to get a rebate of the amounts paid to the customers. While this insured that the customers got the tax rebate, it also set up a system in which the seller had to put his money out for the benefit of the U.S. Government, and hope that he could get it back soon. In essence, the statute contemplated an interest free loan by the seller to the Government.

Some sellers of buses, subsidiaries of General Motors, Trailways, and Greyhound, were able to get swift response by the IRS or cooperative treatment in setting up simultaneous exchange arrangements. But, as is so frequently the case, a small businessman was not successful in dealing with the IRS.

Make no mistake about it, the IRS did not even complete its audit of this small businessman's excise tax returns until after the deadline had passed for making the payments to the bus purchasers. Without the assurance of a completed IRS audit, no bank was willing to lend Harbison Ford the money needed to make the payments to his customers.

What this bill proposes is to extend the time period for making the payment to the customers, and to the vendors that have made application for a refund within the time limits of the original law. I have also proposed paying interest because I think that the Government should pay for the use of other people's money. Further,

the bill contemplates a simultaneous escrow arrangement satisfactory to the Treasury in order to facilitate the refund of these taxes.

Mr. Chairman, the excise taxes to be refunded would amount to less than $350,000, so far as we have been able to determine. The beneficiaries would be 23 different bus purchasers in 12 different States.

Thank you Mr. Chairman.

Mr. VANDER JAGT. Mr. Chairman, I would like to commend the gentleman from Pennsylvania for bringing this issue to the full committee's attention during consideration of the tax bill this year, and for his leadership and initiative in the introduction of H.R. 4408. I think all the wrinkles have been ironed out of this bill, and I commend the gentleman for his work.

Mr. SCHULZE. Mr. Chairman, Mr. Harbison is not a constituent of mine, but he lives in Abington and his business is in Morrisville, Pa. He is a retail Ford dealer who also sells buses, and as far as we can determine, this is the only case where this has caused a problem.

Now, I know the Treasury has estimated a revenue loss of between $1 and $2 million. But the figures that we have show a revenue loss of a little over $300,000. I would like the record to show that, and that we are not dealing with a higher figure.

Chairman STARK. The gentleman's statement will appear in the record.

Mr. Heftel?

Mr. HEFTEL. I just want to congratulate my colleague on this very fair and necessary piece of legislation to provide some degree of fairness to some abused taxpayers, and we have four instances that we are aware of. It was totally unfair, and to this date the dealer has still been unable to make payment, and he is in the throes of whether or not he is going to be sued, and this legislation is needed very quickly if it is going to have value for those who have suffered from our failure to act previously.

Thank you.

Chairman STARK. Mr. Harbison, you have had to sit very quietly and patiently while we all pat ourselves on the back for what a great job we have done. You are the guy who has been suffering through all of this. Maybe we ought to hear from you.

Mr. HEFTEL. I was going to ask Mr. Schulze if he would describe how the escrow would operate.

Mr. SCHULZE. It might be possible for the seller to arrange with his bank to draw certified bank checks for the amounts of the rebates payable to the customers. The IRS might then prepare refund checks payable to the seller, so that as the seller dropped the refund checks in the mail, the IRS could hand over to the bank the amount due the seller in his role as financial intermediary.

Mr. HEFTEL. That could solve the problem if Treasury would cooperate in that provision, and they are not here. Does the chairman know whether the Treasury would cooperate.

Chairman STARK. We can certainly submit that to the Treasury. It would seem to me where there is a will, there is a way.

Mr. HEFTEL. This is about the only way you are going to avoid the necessity for the taxpayer borrowing money at some 20 percent interest, while the Treasury benefits from it.

Mr. SCHULZE. A form of this has been worked out with some of the larger corporations.

Chairman STARK. Is there any objection to two-party checks? Why can't the Treasury draw a two-party check making it, in this case, payable to Mr. Harbison and the customer, and they both have to sign?

Mr. SCHULZE. I think there are several ways it can be worked out, and Treasury and IRS have indicated a willingness to do this.

Mr. HEFTEL. We need a mechanism, and we need it to be something that goes into effect quickly, not waiting for regulations that take a year or two.

Chairman STARK. In the interest of getting along quickly, I suggest we hear from Mr. Harbison, so we can hear what this is all about.

Mr. Harbison, we have your prepared statement, which will appear in the record in its entirety. And if you would like to summarize for us your catch-22 situation. I think we are all aware of what we could do to change it. Please proceed in any way you would like.

STATEMENT OF THOMAS B. HARBISON, PRESIDENT, HARBISON FORD, INC., MORRISVILLE, PA.

Mr. HARBISON. Mr. Chairman, members of the committee, I will summarize my written statement. My name is Tom Harbison, and I am the president of Harbison Ford, Inc. Harbison Ford is an importer and wholesaler of intercity buses. It is located in Morrisville, Pa., a small town outside of Philadelphia. I am here today to testify in favor of H.R. 4408, a bill introduced by Congressmen Schulze, Vander Jagt, Brodhead, and Heftel to remedy inequities created by the operation of section 231(c) of the Energy Tax Act of 1978.

Section 231(c) of the Energy Tax Act of 1978 allowed excise tax refunds to certain manufacturers, producers and importers of intercity buses who paid excise taxes on buses sold during the period for which such taxes were retroactively repeated by section 231(a) of the act. In order to receive the refund, we were required to reimburse the ultimate purchasers of the buses sold during this period prior to receiving our refund, but in no event later than September 5, 1979.

This requirement of prior reimbursement, however, posed a virtual stumbling block to many companies, including mine. During that period of time the general economic condition in our area was bad, particularly so for people in my business. My company did not have the cash to make prior reimbursements. Nor could it borrow the funds necessary, unless we could assure the bank that the IRS had audited our claims and that the receipt of the claimed amount was contingent only upon making reimbursements to our customers.

We filed our claims early, about a month and a half after the tax was repealed. When I had not heard from the IRS for 2 months, I started trying to contact the local IRS office in Philadelphia. I wanted to see if it would be possible for the IRS to audit the claims and contingently approve them so that I could make the arrangements necessary to borrow the funds to reimburse our customers before September 5, 1979. Between February and May 1979, I spoke with five individuals in the Philadelphia office, none of whom could

tell me anything. In June, I sent a formal request for information on the status of our claims. Finally, in August I received a letter telling me that the claims had not yet been assigned to agents and nothing could be done until they were. This was 2 weeks before the deadline for reimbursing customers. The audit was finally begun in October 1979 and completed in January 1980. By this time the statutory deadline had passed.

This legislation is important for several reasons. First, taxpayers who make a good faith attempt to comply with the various procedural requirements for a refund should not be penalized if their inability to comply fully was due largely to circumstances beyond their control. The procedure requiring prior reimbursement to customers was devised to insure that the ultimate purchasers of the intercity buses, who were indeed the real sources of the tax, be the actual recipients of the refund. Although the intention was understandable; in practice, the procedure was burdensome, unfair, and, sometimes, altogether unworkable. For many in the bus industry at that time, particularly smaller importers like Harbison Ford who were cash-poor, this burden was impossible to shoulder. We should not be penalized with the loss of our customers goodwill because we simply did not have the ability, though acting diligently and in good faith, to serve in this capacity as an intermediary for the U.S. Treasury.

Second, after Congress had developed this intricate procedure solely to insure that the ultimate taxpayer—that is, the purchaser—be reimbursed, it would be highly ironic if the purchasers were unable to receive the refund that Congress had so strongly intended because its seller, through no fault of its own, could not reimburse the purchaser prior to receipt of the refund. The ultimate taxpayers were given no authority in the act to seek a refund directly.

Finally, some sellers were able to secure the cooperation of the Internal Revenue Service in performing audits of refund claims. Those who tried, but for unknown reasons were not able to secure this cooperation, should not be in a worse position than those who were able to secure cooperation. Nor should their customers be in a worse position.

Congress intended that certain tax payments made indirectly by the purchasers of intercity buses be refunded to all such purchasers. Congress did not intend that purchasers from one class of sellers receive the refund and that other purchasers from financially weaker sellers not receive the refund. Congress also did not intend to cause such financially weaker sellers the loss of their customers goodwill because, due to circumstances beyond their control, they could not reimburse their purchasers before receiving their refunds.

The diligent, but financially weak, sellers should not and cannot be held to account. The equally innocent ultimate taxpayer who made a purchase from such a seller should not be without relief. Congress should act to guarantee that these taxpayers receive their refund from the Treasury just as have other similarly situated taxpayers. Thus, I support H.R. 4408, which would permit the customers of Harbison Ford to receive refunds of excise taxes total-

ling $341,834 by allowing simultaneous reimbursement, rather than prior reimbursement, to customers.

Thank you very much, sir.

[The prepared statement follows:]

STATEMENT OF THOMAS B. HARBISON, PRESIDENT, HARBISON FORD, INC.

I am Thomas B. Harbison, president of Harbison Ford, Inc., a Ford Motor Company dealership located on Route 1, Morrisville, Pennsylvania 19067 (telephone number (215) 736-0092) ("Harbison Ford"). Harbison Ford is an importer, wholesaler and retailer of intercity buses. I am appearing here today as a witness in favor of H.R. 4408, the bill introduced by Representatives Schulze, Vander Jagt, Brodhead and Heftel, to provide relief to certain manufacturers, producers and importers and ultimate purchasers of intercity buses who did not receive the refunds of federal excise taxes with respect to buses granted by Congress in section 231(a) of the Energy Tax Act of 1978 (the "Act").

SUMMARY

Section 231(c) of the Act provided for refunds to certain manufacturers, producers and importers of intercity buses of excise taxes paid with respect to buses sold during the period for which such excise taxes were retroactively repealed by section 231(a) of the Act. In order to receive a refund, a manufacturer, producer or importer of intercity buses which had sold buses during the retroactive repeal period was required to reimburse the ultimate purchasers of the buses sold during the relevant period prior to receiving its refund, but in no event later than September 5, 1979. H.R. 4408 would amend section 231(c) of the Act to provide that the reimbursement of ultimate purchasers may be made until December 31, 1982. In addition, it would amend section 231(c) of the Act to provide that, in lieu of making prior reimbursements to ultimate purchasers of buses, the manufacturer, producer or importer could reimburse the ultimate purchaser simultaneously while receiving its refund.

I am happy to testify in support of H.R. 4408 because this bill would remedy the inequitable and, I believe, unintended predicament which my company and our customers face. When section 231 of the Act was enacted, Harbison Ford filed timely claims for refund with respect to intercity buses sold during the retroactive repeal period. However, because of its financial position and the general economic situation in the area in which it is located, Harbison Ford was completely without means to reimburse its customers without first receiving its refund. Moreover, Harbison Ford could not obtain the credit necessary to make the reimbursements unless it could show a potential lender that its claims for refund had been audited by the Internal Revenue Service and that the payment of refunds, in the amounts claimed, were conditioned only upon reimbursements being made to ultimate purchasers. Many attempts were made to persuade the Philadelphia District Office of the Internal Revenue Service to cooperate in completing the audit with respect to the claims. However, unlike certain other taxpayers, Harbison Ford was not able to secure this cooperation and the audit was not completed by the Internal Revenue Service until January 1980, several months after the deadline for making reimbursements to ultimate purchasers.

DISCUSSION

Harbison Ford, an importer, wholesaler, and retailer of intercity buses, paid federal excise taxes pursuant to sections 4061(a) and 4226 of the Internal Revenue Code of 1954, as amended ("Code"), with respect to buses sold to ultimate consumers and to dealers during the period beginning April 20, 1977, and ending October 15, 1978, the date that the Act was enacted. Section 231(a) of the Act retroactively repealed the federal excise tax imposed by section 4061(a) of the Code on sales of buses to ultimate purchases made between April 20, 1977, and October 15, 1978, and the federal excise tax imposed by section 4226 of the Code on floor stocks of buses held by dealers during such period. In accordance with the provisions of section 231 (b) and (c) of the Act, Harbison Ford filed Claims for Refund, Treasury Forms 843 ("Claims"), on or about November 23, 1978, for federal excise taxes on buses sold by it to ultimate purchasers and dealers holding floor stocks in each affected calendar quarter. Acknowledgement of receipt of the Claims by the Chief of the Taxpayer Assistance Section of the Philadelphia District Office was made on December 12, 1978.

Harbison Ford was aware that before it could receive a refund of the repealed taxes with respect to buses sold to ultimate purchasers, it was required to reimburse the ultimate purchasers of the buses sold in the amount of the excise taxes paid.

Section 231(c)(2)(A) of the Act; Temporary Treasury Regulations sections 138.1-2(c)(2) and (3). Unfortunately, Harbison's Ford's financial position prevented it from making the necessary reimbursements without first receiving its refund. Also, Harbison Ford determined that it could not obtain the credit necessary to reimburse its customers unless it could show a potential lender that its Claims had been audited and that its refunds, in the amount of its Claims, were conditioned only upon reimbursements being made to its customers.

Realizing that Harbison Ford had this problem, I contacted individuals in both the Taxpayer Assistance Section and the Excise Tax Group of the Philadelphia District Office of the Internal Revenue Service in an attempt to arrange to have an audit with respect to the Claims commenced prior to reimbursement of customers, with actual approval of the Claims being conditioned upon the making of the reimbursements. For various reasons (some of which are entirely unknown to me), the audit that I requested was not begun until October 26, 1979, which was approximately one and one-half months after September 5, 1979, the deadline by which reimbusements were required by section 231(c)(2) of the Act to be made to customers. The audit of the Claims was not completed until January, 1980.

Harbison Ford struggled to attract the attention of someone in the Philadelphia District Office of the Internal Revenue Service in order to make arrangements for an early audit. Harbison Ford filed its Claims early, in November, 1978, nine months prior to the statutory deadline. Two months after the filing of the Claims, it began contacting individuals in the Philadelphia District Office. From February, 1979, through May, 1979, it contacted five individuals, most of whom directed it elsewhere.

On May 11, 1979, Leon Trust of the Philadelphia District Office went to Harbison Ford to perform an audit. When I was notified of Mr. Trust's visit, I thought Mr. Trust was coming to perform the audit with respect to the Claims. What ensued, however, was a regular income tax audit of Harbison Ford for the year 1977. While Mr. Trust was at Harbison Ford, I discussed the problem relative to reimbursing ultimate purchasers with him. Apparently nothing more came of the conversation until October 26, 1979, when Mr. Trust returned to perform an audit with respect to the Claims.

On June 25, 1979, a letter was sent to the Philadelphia District Office requesting information on the status of the Claims. This letter was finally answered on August 22, 1979, approximately two weeks before the deadline for reimbursing customers. The letter stated a Problems Resolution Specialist was working on the case and would contact Harbison Ford. After receipt of the letter, the controller of Harbison Ford called the Philadelphia District Office and was told that a Mr. E. Brown, who apparently was then in charge of the matter, had died, and the matter had to be reassigned. A second call produced the information that Mr. Trust had the Claims and was the person to contact. Finally, on October 26, 1979, an audit of and investigation into the Claims was begun by Mr. Leon Trust. On November 13, 1979, I spoke with Mr. Trust who stated that the audit begun on October 26, 1979, could not proceed until "the Claims came out of the computer". In an effort to expedite the matter, I contacted Mr. Morton Kaffrisson of the Excise Tax Group who advised me that the Claims were still in the computer. Mr. Kaffrisson also advised me that he had been transferred and was no longer in charge of the Harbison Ford case. Mr. Kaffrisson notified me that William Walton of the Excise Tax Group was now in charge of the case.

Finally, in January, 1980, the audit with respect to the Claims was completed. Harbison Ford's floor stock refunds in the amount of $53,978.76, were approved. However, refunds of federal excise taxes with respect to sales of buses to ultimate purchasers, in the total amount of $341,833.61, were not approved because reimbursements had not been made to customers prior to September 5, 1979, as required by section 231(c) of the Act and Temporary Treasury Regulation section 138.1-2(c)(2)(iii). This was the only reason the refunds were not approved.

By the time the audit was performed, the deadline for making reimbursements had passed. Harbison Ford was, as a result, unable to obtain the information and assistance necessary to make timely reimbursemen' Nevertheless, we began working very closely with Mr. Walton of the Philadelphia District Office in an attempt to resolve the matter in a manner which would enable Harbison Ford to reimburse its customers and ultimately receive the claimed refunds as intended by Congress. In this regard, Harbison Ford, with the cooperation of the Philadelphia District Office, requested technical advice from the National Office of the Internal Revenue Service in April, 1980. Unfortunately, because the deadline for reimbursing ultimate purchasers of intercity buses was statutory, and not regulatory, we were advised that the National Office of the Internal Revenue Service had no authority to extend the deadline, even in light of the circumstances. The request was denied on this basis,

and a representative of the National Office suggested that the appropriate vehicle to provide relief would be remedial legislation.

H.R. 4408 is very important to a small intercity bus importer like Harbison Ford, which made a good faith effort to comply with the procedural requirements of section 231(c) of the Act and the regulations promulgated thereunder, but which was not able to comply fully, due largely to circumstances beyond its control. As is evidenced from the above discussion, Harbison Ford attempted, to the best of its ability, to comply with the requirements of section 231(c) of the Act. It did substantially comply with all of the prerequisites to a refund except the requirement that customers be reimbursed prior to September 5, 1979.

As stated above, it was impossible, without the cooperation of the Internal Revenue Service, for Harbison Ford to reimburse ultimate purchasers before it received its refund and, thus, before September 5, 1979. Without prior refund, Harbison Ford did not have, nor does it now have, the funds necessary to make reimbursements totalling $341,833.61 to its customers. Furthermore, Harbison Ford could not borrow the funds necessary to make the reimbursements. Harbison Ford was already deeply in debt. Its line of credit with Ford Motor Credit Company for new cars was overdrawn by fifty percent during the summer of 1979. Thus, because of its financial position, Harbison Ford could not borrow the necessary funds to make customer reimbursements unless it could show a potential lender that its entitlement to a refund was conditioned only upon the making of the reimbursements. Harbison Ford could have made the representations necessary to obtain financing only if the Internal Revenue Service had completed an audit prior to September 5, 1979, reviewed all the evidence except the reimbursements, and reported that the granting of Harbison Ford's refunds, in the aggregate amount of $341,833.61, were contingent only upon the making of reimbursements to ultimate purchasers of that amount.

Notwithstanding Harbison Ford's lack of success in obtaining cooperation from the Internal Revenue Service, it is my understanding that other taxpayers were able to secure such cooperation. It is my further understanding that a total of only five intercity bus manufacturers and importers were affected by the repeal of the federal excise tax on buses, section 231 of the Act, and of these, at least two other than Harbison Ford found it difficult or impossible to obtain the funds necessary to reimburse their customers prior to receiving refunds. In both of these cases, the Internal Revenue Service reputedly cooperated with the taxpayers in adjusting the procedures used in approving refunds so that the financial problems involved could be resolved. The two manufacturers involved were Motor Coach Industries ("MCI") and Eagle International, Inc. ("Eagle"). I have been informed that the following are the facts surrounding their respective circumstances.

MCI is a bus manufacturer located in California whose major customer is Greyhound Buslines. Reportedly, MCI filed its claim for refund early in June without having first reimbursed its customers. It was not able to acquire the funds necessary to reimburse its customers prior to receiving its refund. MCI would only have been able to obtain the necessary funds upon making the representation to lenders that the only remaining refund requirement to satisfy was the making of the reimbursements.

After much effort on the part MCI, the Internal Revenue Service finally agreed to audit MCI with respect to its claim for refund. MCI's parent company used its efforts to obtain the early audit. Also, Greyhound Buslines assisted in MCI's behalf. Thereafter, the books of MCI were audited and it was determined that the only condition precedent to the issuing of a refund to MCI was the making of the reimbursement.

The Internal Revenue Service agreed to expedite the issuing of the refund to MCI after MCI gave the Internal Revenue Service its commitment to issue reimbursement checks to its customers on July 20, 1979. MCI issued its checks on such date. It then received its refund approximately two weeks later.

Eagle is a bus manufacturer located in Brownsville, Texas which supplies buses primariy to Trailways, Inc. and its subsidiaries. Like MCI and Harbison Ford, Eagle found itself unable to make reimbursements to its customers prior to that time that it obtained its refund. Unlike MCI and Harbison Ford, however, Eagle could not have obtained financing even on the strength of a representation that the only condition precedent to its receipt of its refund was reimbursement of its customers. Its claim for refund was in the amount of approximately two million dollars, most of which was to be reimbursed to Trailways, Inc. and its subsidiaries.

In August, 1979, the office of the District Director of the Austin, Texas District agreed to a special procedure. The Internal Revenue Service audited the books of Eagle to determine whether, with the exception of the prior reimbursements having been made to the ultimate purchasers, all requirements for a refund had been

satisfied and to determine what the amount of the refund would be if reimbursements were made to ultimate purchasers. The District Director then agreed to approve the claim and the writing of the checks, but not the mailing of the checks. Eagle had cashier's checks prepared to cover required reimbursements, but did not mail the reimbursement checks to its customers.

Simultaneously therewith, Eagle and its banker arranged with a sister bank of the banker located in Austin, Texas, to open an escrow account into which the refund check would be deposited. The escrow agreement with the bank contained provisions which prohibited Eagle from withdrawing funds from the account. The only withdrawals could be by the honoring of the cashier's reimbursement checks that were to be mailed to Eagle's customers. In the event that any such checks were not presented to the escrow agent, such checks would be voided and the total amount thereof would be refunded to the United States Government by the issuance of a cashier's check payable thereto and hand delivered to the District Director in Austin, Texas.

The Internal Revenue Service then deposited the refund checks in the escrow account. The checks from Eagle to its customers, which were cashier's checks drawn on the bank acting as escrow agent, were put in the United States mail simultaneously with the United States Government refund checks being deposited in the escrow account. This entire procedure took place within one week of the September 5, 1979 deadline.

In conclusion, Mr. Chairman, this legislation is important for several reasons. First, taxpayers who made a good faith attempt to comply with the various procedural requirements of the Act and appropriate regulations thereunder should not be penalized if their inability to comply fully was due largely to circumstances beyond their control The Congress permitted the Treasury to require, and the Treasury did require, that these taxpayers reimburse their customers for previously paid taxes before receiving from the Treasury a refund in the amount of the reimbursements. This administrative procedure was clearly devised to ensure that the ultimate purchasers of the intercity buses who were indeed the real sources of the tax revenue be the actual recipients of the tax refund. Although the intention of this procedure was understandable; in practice, the mechanism proved burdensome, unfair, and, sometimes, altogether unworkable. This procedure actually imposed upon the "intermediary" taxpayer the burden of being short the amount of cash which it was required to reimburse its customers from the time of such reimbursement to the time it received its refund. For many in the bus industry at that time, particularly smaller importers who were cash-poor, this burden was impossible to shoulder. For those taxpayers who were willing to borrow funds and incur the interest expense of doing so to comply with the statutory and regulatory scheme but unable to do so without appropriate cooperation from the Internal Revenue Service, this procedure proved cumbersome and often unworkable. In such circumstances, such taxpayers should not be penalized with the loss of their customers' good will because they simply did not have the ability, even though acting diligently and in good faith, to serve in this unusual capacity as an intermediary for the United States Treasury.

Second, after the Congress had developed and instigated such an intricate procdure solely to ensure that the "ultimate" taxpayer be reimbursed certain tax payments, it would be highly ironic if, because the "intermediary" taxpayer through no fault of his own could not make the reimbursement prior to receipt of the refund, the "ultimate" taxpayers were unable to receive the refund that Congress had so strongly intended. The ultimate taxpayers were given no authority in the Act to seek a refund directly. Whether such taxpayers have obtained the intended refund has depended upon the financial strength, or lack thereof, of the respective "intermediaries" through which the refund was designed to flow from the Treasury to the "ultimate" taxpayers. This result is entirely inequitable.

Finally, some "intermediary" taxpayers, such as those described above, were able to secure the cooperation of the Internal Revenue Service. Those who tried, but for unknown reasons were not able, to secure this cooperation, should not be in a worse position than those who were able to secure cooperation. Nor should their customers be in this situation merely because their seller, the only entity that could claim a refund, did not have the ability to secure the cooperation of the Internal Revenue Service.

The Congress intended in the Act that certain tax payments made indirectly by the purchasers of certain mass transit vehicles be refunded to all such purchasers. The Congress did not intent that purchasers from one class of "intermediaries" receive the refund and that other purchasers from financially weaker "intermediaries" not receive the refund. The Congress also did not intend to cause such financially weaker "intermediaries" the loss of their customers' good will because, due to

circumstances beyond their control, they could not reimburse their purchasers before receiving their refunds.

The diligent, but financially weak, "intermediary" taxpayer should not and cannot be held to account. The equally innocent "ultimate" taxpayer who made a purchase from such an "intermediary" should not be without relief. The Congress should act to guarantee that these taxpayers receive their refund from the Treasury just as have other similarly situated taxpayers. Thus, I support H.R. 4408 which would give the opportunity to Harbison Ford and other similarly situated taxpayers to secure for their customers the refund of retroactively repealed excise taxes by allowing simultaneous reimbursement, rather than prior reimbursement, to customers.

Chairman STARK. Thank you, Mr. Harbison. It is often the duty of this committee to address inequities, and it is often hard to sort out when one person's inequity is another person's windfall, I suppose. It has often been said that all too often the only people who can afford to get here are large businesses who have extensive counsel and tax help, and it is often too bad that people like yourself have to go through the long and arduous route of dealing with the bureaucracy. And I know that each of us as individuals would like to see that our constituents don't receive inequities at the hands of the bureaucracy, or run into the problems that you did. It does happen. It is awfully hard to build a perfect world, and so again I would apologize for all the troubles I know you have had.

I reviewed your case. I understand the bank's reluctance to lend money to a point, and I understood the IRS. I must compliment the lending officer for seeing the pitfall in that. I have a feeling that—at least I speak for myself—that your case has merit, and with the support of the Treasury, I think, but for some technical questions, I would certainly recommend to my colleagues on the committee that we do something about correcting it. And as you may or may not know, it is not very often that I feel that way about cases of relief for particular taxpayers.

I appreciate your taking the time to come here today.

Mr. Duncan?

Mr. DUNCAN. I have no questions. Thank you for your statement.

Chairman STARK. Mr. Heftel?

Mr. HEFTEL. No questions.

Chairman STARK. Mr. Schulze?

Mr. SCHULZE. Other than to thank Tom for his appearance and his presentation, I have no questions. I would be happy to answer any questions that the committee may have of me.

Chairman STARK. I would submit if you and Mr. Heftel wanted to have an exchange for the record, you could submit that later, and we will keep the record open.

Mr. SCHULZE. The main thing we wanted to get on the record was a message to the IRS that we feel they should be most cooperative in the method of payment on this thing. However they work it out to their convenience is all right, as long as they do it promptly. We are going to be looking over their shoulders.

Mr. HEFTEL. I want to confirm the observations of the witnesses, Mr. Schulze, and the chairman, and to be sure IRS does realize this is an abuse of a certain limited number of taxpayers, and only we, the Congress, and the IRS can rectify it. So far IRS has not done it, and that is why Congress has to.

Chairman STARK. Mr. Russo?

Mr. RUSSO. No questions.

Chairman STARK. Mr. Moore?

Mr. MOORE. No questions.

Chairman STARK. Thank you very much.

The next witness is Mr. Daniel J. Brennan, vice president for taxes and insurance, Consolidated Foods Corp.

Welcome to the committee. We have your testimony, and without objection your complete statement will appear in the record, and you may proceed to comment on your statement or the comments made by the Secretary of the Treasury this morning, if you were present for those. Proceed in any fashion you desire.

STATEMENT OF DANIEL J. BRENNAN, VICE PRESIDENT, TAXES AND INSURANCE, CONSOLIDATED FOODS CORP.

Mr. BRENNAN. Mr. Chairman, and members of the subcommittee, I am Daniel J. Brennan, vice president, taxes and insurance, of Consolidated Foods Corp., a Chicago based company, which is primarily engaged in providing consumer packaged goods to the public. I am pleased today to have an opportunity to comment on H.R. 3581, introduced by Congressman Russo. This bill excludes certain foreign commodity-derived income from treatment as subpart F income. Passage of this bill would correct what we consider to be an inequity in the tax law.

Consolidated Foods Corp. owns a 65-percent interest in a Dutch company named Douwe Egberts Koninklijke Tabaksfabriek-Koffiebranderijen—Theehandel B.V. The remaining 35 percent is owned by Dutch nationals. Douwe Egberts is a very large multinational company with sales in excess of $1 billion. It has been in existence for centuries; to be precise, it was founded in 1753. Consolidated Foods Corp. purchased its interest in 1978 in order to gain a big position in European markets since Douwe Egberts trades in many consumer products such as coffee, tea, tobacco, spirits, and so forth.

Among the many subsidiaries of Douwe Egberts is a large international coffee trading company incorporated in Switzerland. It was of interest to me that Switzerland is one of the largest coffee trading centers in the world, where about 25 percent of the world's coffee is bought and sold. The Douwe Egberts subsidiary in Switzerland, which is called Decotrade, buys coffee from the various coffee growing countries and sells to both related and unrelated companies. The income generated by Decotrade on this business is exempt from taxation as subpart F income because coffee is not grown in commercially marketable quantities in the United States. This particular exemption from subpart F income was adopted as part of the Tax Reduction Act of 1975. The purpose of that amendment was to recognize the fact that avoidance of U.S. tax was not likely to be involved in trading commodities not grown in the United States.

Our problem arises on the payment of a dividend from Switzerland to Holland. Our interpretation of the Code was that a dividend from Switzerland to Holland would be exempt under section 954(b)(4) since it was our view that we had met the requirements of that provision. Because Douwe Egberts was planning a significant dividend from Switzerland to Holland, we applied to the Internal Revenue Service for a ruling that such a dividend was indeed

exempt from subpart F income. The IRS refused to rule favorably. What we are seeking here, then, is, in essence, a clarification of section 954(b)(4).

The inequity I mentioned earlier comes about as a result of the fact that if Douwe Egberts operated in Switzerland as a branch, the earnings would not be subject to U.S. taxation. But because they have chosen to operate as a subsidiary, movement of earnings from Switzerland to Holland are treated as subpart F income. I should emphasize that the foreign taxes levied against Decotrade's earnings would be the same whether Decotrade was a branch or a subsidiary.

There has been no attempt on our part to shift what would otherwise be U.S. income in order to escape U.S. taxation, since Decotrade has been in existence since 1969, a number of years before we purchased our interest in Douwe Egberts. If Decotrade were merged or liquidated, there would be a significant Swiss tax to pay.

We at Consolidated Foods Corp. believe that the IRS interpretation of the tax law produces an inequity wherein the form of the transaction dictates its tax treatment. In our view, this is a violation of the general tax concept that substance prevail over form.

Since Dutch tax authorities require that the Swiss operations pay dividends periodically to the Dutch parent, we are in a position of paying a U.S. tax on income that we will probably never receive because of the large minority interest in Douwe Egberts. This is particularly burdensome when one considers that Douwe Egberts pays an annual cash dividend which usually amounts to 40 percent of their earnings. The cash dividends we receive, of course, are subject to U.S. tax at ordinary rates.

Consolidated Foods Corp. and Douwe Egberts are placed in a severe competitive disadvantage with respect to their European operations as a result of this problem. We believe that a correction of this situation is only fair and this amendment, in our judgment, will not, in any way, adversely affect the policies incorporated in subpart F.

Thank you, Mr. Chairman, and members of this subcommittee, for giving me the opportunity to appear before you to express our views.

[The prepared statement follows:]

STATEMENT OF DANIEL J. BRENNAN, VICE PRESIDENT, TAXES AND INSURANCE, CONSOLDIATED FOODS CORP.

Mr. Chairman and members of the Subcommittee, I am Daniel J. Brennan, Vice President—Taxes and Insurance of Consolidated Foods Corporation, a Chicago-based company which is primarly engaged in providing consumer-packaged goods to the public. I am pleased today to have an opportunity to comment on H.R. 3581, introduced by Congressman Marty Russo. This bill excludes certain foreign commodity derived income from treatment as foreign personal holding company income.

Present Law.—Under present law, the earnings of foreign corporations owned or controlled by U.S. persons are generally subject to U.S. income tax only when they are actually remitted to the U.S. shareholders as dividends. This procedure is generally referred to as "deferral."

In 1962, in response to a request by President Kennedy, Congress enacted partial repeal of "deferral" in what is commonly referred to as "subpart F" of the tax law. At that time, the President emphasized the removal of tax deferral in the case of what has been called "tax havens." These tax havens were being used by American firms who arranged their corporate structures to significantly reduce or eliminate

their tax liabilities both at home and abroad. However, certain of the subpart F rules were adopted in order to meet the problem of diversion of income from U.S. taxation.

There are five categories of income which the Congress decided to tax currently to the U.S. shareholder of a controlled foreign corporation because they fall either into the tax haven category or into situations where there is an attempt to escape tax by shifting U.S. income abroad. These five categories include: (1) income from the insurance of U.S. risks; (2) passive investment income such as dividends, interest, royalites, and rents (referred to as foreign personal holding company income); (3) sales income earned by the foreign subsidiary on the sale of property purchased from, or sold to, a related company if the property was neither manufactured in nor sold for use in the country in which the subsidiary is incorporated (referred to as foreign base company sales income); (4) income from services performed by the foreign subsidiary outside of the country in which it is incorporated (referred to as foreign base company income); and (5) shipping income earned by a foreign subsidiary outside of the country in which it is incorporated, if that income is not reinvested in shipping assets (referred to as foreign base company shipping income).

In considering possible investment income such as dividends to be tax haven type income, the Congress recognized the need to maintain active American business operations abroad on a competitive footing with other operating businesses in the same foreign countries. However, the Congress saw no need to maintain deferral of U.S. tax on income from portfolio investments. But there were a number of exceptions to the rule of taxing foreign personal holding company income.

In 1969, the Code was amended to broaden and clarify one exception. By amending Section 954(b)(4), an item of income received by controlled foreign corporation was excluded from foreign base company if both the creation or acquisition of the controlled foreign corporation and the effecting of the transaction giving rise to the income did not have as one of its principal purposes a substantial reduction of income taxes. The rationale behind this exception was that facts and circumstances should sometimes prevail where tax avoidance was not a motivating force in the transaction.

Later, the Tax Reduction Act of 1975 adopted an exclusion to the taxation provisions of subpart F for income arising from the sale between related parties of agricultural commodities which are not grown in the U.S. in commercially marketable quantities. The rationale of that amendment was obviously that since the activity could not have been performed in the U.S. under any circumstances (because the commodities were not grown in commercially marketable quantities here) that no avoidance of U.S. taxation was involved. So, there is a history of granting exceptions where inequities could be shown.

Consolidated Foods Corporation's Operations Abroad.—Consolidated Foods Corporation owns a 65 percent interest in a company, Douwe Egberts Koninklijke Tabaksfabriek-Koffiebranderijen-Theehandel, B.V., which is incorporated in the Netherlands. Douwe Egberts is a large multi-national company which has been in existence for centuries. To be precise, it was founded in 1753. Consolidated Foods purchased its interest in 1978 in order to quickly penetrate the European markets.

Douwe Egberts trades in consumer products such as tobacco, tea, coffee, spirits, etc. Among its many subsidiaries is a wholly-owned company in Switzerland named Decotrade. It is of interest that Switzerland is one of the major international coffee trading centers of the world. Decotrade is a major international coffee trading operation. It buys from any number of coffee growing companies and sells not only to its sister companies around the world, but also to unrelated parties. The income generated therefrom is exempt from taxation as subpart F income because coffee is not grown in commercially marketable quantities in the U.S. This exemption would apply whether Douwe Egberts earned the income by performing the coffee trading either through a branch or through a subsidiary in Switzerland. However, if Decotrade, the Swiss coffee trading subsidary, declares as dividend (from its coffee earnings) to Douwe Egberts, the present U.S. tax law reclassifies the income in Douwe Egbert's hands from that of exempt coffee income to taxable dividend income. This anomaly occurs because dividends, whether from subsidiaries or from unrelated companies, are deemed by the Internal Revenue Code to foreign personal holding company income. (It should be emphasized that this would not be the case if the company had earned the income through a branch. Additionally, if Decotrade were a branch, the Dutch would not tax the operations, since they are taxed in Switzerland.)

We had been of the opinion, as did our tax counsel, that a dividend from Decotrade to Douwe Egberts would be exempt from subpart F treatment under Section 954(b)(4). The I.R.S. refused to so rule, apparently under the theory that no outside compulsion to pay dividends could be shown. This appears to us to be an unduly

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restrictive interpretation of the statute. We at Consolidated Foods believe the current interpretation by the I.R.S. produces an inequity, and H.R. 3581, in essence, redresses that interpretation.

Even if Section 954(b)(4) did not exist, there still would be, in our view, an inequity. Clearly, the form of the transaction is dictating the tax treatment here. This is a violation of the general tax concept that substance should prevail over form.

We should point out that there has been no attempt on our part to move what would otherwise be U.S. income abroad in order to escape U.S. taxation. This income, whether earned directly through a branch or indirectly through a subsidiary, should not be taxed to us under subpart F.

The foreign personal holding company rules were originally included in the subpart F provisions in order to tax passive types of income where income is not needed in the normal operations of a business. Although the coffee trading income is received by Douwe Egberts as income classified as dividend, it is not truly passive income not needed in its operations. The coffee trading income, when repatriated to Douwe Egberts, will be retained to be used in its normal business activities. In fact, the Dutch tax authorities insist upon the payment of such a dividend to preclude Douwe Egberts from borrowing to fund its business operations and deducting the interest for Dutch tax purposes. Douwe Egberts is hard pressed to argue that if a dividend is paid, significant tax ramifications occur to its parent under the U.S. subpart F rules. It should be noted that the funds are used, in part, to pay a cash dividend of approximately 40 percent of earnings, to its shareholders. To sum up, there is no U.S. tax policy being circumvented here, no U.S., tax being avoided, no use of tax havens. Nonetheless, the impact of the law is that Douwe Egberts and Consolidated Foods have been placed in a severe competitive disadvantage in trying to run their European operations.

We believe that the current situation is inequitable, and that the correction of this situation will not in any way adversely affect the operation of the policies incorporated in subpart F.

Thank you, Mr. Chairman, and members of the Subcommittee for giving me the opportunity to appear before you to express our views.

Chairman STARK. Thank you. I have two questions, Mr. Brennan.

Mr. BRENNAN. Yes, sir.

Chairman STARK. If your Swiss company in fact was merged with the Dutch company, would your problem cease to exist?

Mr. BRENNAN. We would have to pay a large Swiss tax to do that. We also trade with nonrelated companies and we want to limit our liability in those situations.

Chairman STARK. I have some problem in correcting things in the Code for the benefit of one particular taxpayer, particularly when there may be another way of doing it.

Second, there are really two parts to the bill, and the other troubles me, because we have had a long-standing policy against retroactivity. In other words, I think we have two questions here. Whether to change the definition, and then whether, if we did change the law, to make the changes retroactive. And one assumes the only reason it is retroactive, is that there is some money that would be refunded?

Mr. BRENNAN. We have been working on the problem for sometime. The language essentially is the Treasury's language, and the date was the date put in when we worked on this some years ago. We could accept the change in the date to indicate prospective.

Mr. Duncan?

Mr. DUNCAN. I have no questions. I do want to thank you for being here.

Chairman STARK. Mr. Russo?

Mr. RUSSO. Thank you very much, Mr. Chairman. There are other ways of changing this inconsistency in the law that wouldn't cause the taxpayer a lot of inconvenience and money, and it was for the IRS to realize, if they looked at the facts and particular

circumstances, that they could have ruled under existing provisions that consolidated shouldn't have paid any taxes on this income. This income should remain tax exempt; the IRS has refused to so rule. Instead, we are asking a company to merge. I think a problem that IRS has is in dealing with substance as opposed to form. This is a particular case where the IRS can look at the facts and circumstances and make a decision and not require the Congress to come in and change legislation. They have refused to do that, leaving Consolidated Foods only one other recourse, to come to Congress to clarify through legislation the intent Congress had in enacting this particular code provision in the first place.

Is this income considered passive income by the corporation?

Mr. BRENNAN. No. The income is used for the operation of the business, to pay dividends, to buy the products they buy and sell.

Mr. RUSSO. Are the proceeds of the sale of the coffee used in the operation?

Mr. BRENNAN. Yes, sir.

Mr. RUSSO. I see, and as I understand it, Mr. Chairman, the original corporation was set up in 1750's. The other corporation was set up in 1959, so the transactions in question were not done for purposes of tax deferral or evasion.

The facts and circumstances would indicate that there is justifiable reason why this income should be exempt. The IRS could have corrected the situation themselves.

I thank the gentleman for appearing here.

Chairman STARK. Mr. Moore?

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Brennan, did your company take the IRS to court over this issue?

Mr. BRENNAN. No, we didn't. In order to take them to court, we would have a dividend declared from Switzerland to Holland in a given taxable year. Then we could file a tax return, and by the time we could get to court it would be maybe 8 years from the time of the original transaction. That is a long time for us to hang in the air.

Mr. MOORE. You couldn't get a declaratory judgment without having declared the dividend?

Mr. BRENNAN. I don't think we could have done that.

Mr. MOORE. Are you certain of that?

Mr. BRENNAN. No, I am not certain of that.

Mr. MOORE. It looks a bit like you are coming to the Congress asking for congressional redress of something the courts could just as easily handle. If we make a change, I would only vote for a prospective effective date.

I thank the Chair.

Chairman STARK. Thank you very much. Again, I am always troubled when people have to go to the inconvenience and the trouble I know that you do for problems with the code, and the committee appreciates your testimony. Thank you.

That completes the witness list and the hearing, and the subcommittee is adjourned.

[Whereupon, at 12 noon, the hearing was adjourned.]

APPENDIX

There follows the text, summary, and written comments received on bills which are the subject of this hearing.

Restrictions on Deduction for Business Use of Homes and Rental of Residences to Family Members (Code sec. 280A)

97TH CONGRESS
1ST SESSION

H. R. 588

To amend the Internal Revenue Code of 1954 to provide that certain rentals to members of the taxpayer's family will not be treated as personal use by the taxpayer for purposes of the disallowance of certain expenses in connection with the business use of homes, rental of vacation homes, etc.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 5, 1981

Mr. ROYBAL introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to provide that certain rentals to members of the taxpayer's family will not be treated as personal use by the taxpayer for purposes of the disallowance of certain expenses in connection with the business use of homes, rental of vacation homes, etc.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subparagraph (A) of section 280A(d)(2) of the Internal Revenue Code of 1954 (defining personal use of dwelling unit) is amended to read as follows:

"(A) for personal purposes—

"(i) by the taxpayer or any other person who has an interest in such unit, or

"(ii) by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person but only if—

"(I) such use is not during a period for which such dwelling unit is rented by such member for a rental which, under the facts and circumstances, is fair rental,

"(II) such member has not attained age 60, and

"(III) such member is not permanently and totally disabled (within the meaning of section 105(d)(4));".

(b) Paragraph (2) of section 280A(d) of such Code is amended by adding at the end thereof the following new sentence: "Subparagraph (C) shall not apply to any member of the family (as defined in section 267(c)(4)) of the taxpayer or of any other person who has an interest in the unit.".

(c) Subparagraph (B) of section 280A(d)(3) of such Code (defining qualified rental period) is amended by striking out "other than a member of the family (as defined in section 267(c)(4)) of the taxpayer".

(d) The amendments made by this section shall apply to taxable years beginning after December 31, 1980.

97TH CONGRESS
1ST SESSION

H. R. 890

To amend the Tax Reform Act of 1976 to postpone the effective dates of the family rental tax.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 16, 1981

Mr. MARTIN of North Carolina introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Tax Reform Act of 1976 to postpone the effective dates of the family rental tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 601(c) of the Tax Reform Act of 1976 (relating to deductions for expenses attributable to business use of homes, rental of vacation homes, etc.), is amended by striking out "1975" and inserting in lieu thereof "1981".

97TH CONGRESS
1ST SESSION

H.R. 1177

To amend the Internal Revenue Code of 1954 to repeal the Family Rental Tax.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 22, 1981

Mr. PEPPER (for himself, Mr. PASHAYAN, Mr. ROUSSELOT, Mr. LUNGREN, Mr. LAFALCE, Ms. OAKAR, Mr. MATTOX, Mr. OTTINGER, Mr. KOGOVSEK, Mr. LAGOMARSINO, Mr. DICKINSON, Mr. CHAPPELL, Mr. ROTH, Mr. D'AMOURS, Mr. MURPHY, Mr. BOWEN, Mr. BIAGGI, Mr. MCDONALD, Mr. FORSYTHE, Mr. PANETTA, Mr. ANTHONY, Mr. HUGHES, Mr. GUYER, Mr. TRAXLER, Mr. FLIPPO, Mr. BARNES, and Mr. DANIEL B. CRANE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to repeal the Family Rental Tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subparagraph (A) of section 280A(d)(2) of the Internal Revenue Code of 1954 (relating to personal use of a unit) is amended by inserting before the semicolon at the end thereof the following: "(unless such member of the family pays a rental which, under the facts and circumstances, is

fair rental and uses the unit as their principal place of residence)."

(b) Section 280A of the Internal Revenue Code of 1954 is amended by striking from section (d)(3)(B) the words: "to a person other than a member of the family (as defined in section 267(c)(4)) of the taxpayer,".

(c) The amendments made by this Act shall apply to all taxable years to which section 280A applies.

97TH CONGRESS
1ST SESSION

H. R. 1290

To repeal the family rental home business tax; to amend the Internal Revenue Code of 1954 with respect to the deduction of certain expenses in connection with the business use of homes and the rental of residences to family members, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 27, 1981

Mr. BAFALIS (for himself, Mr. WHITTAKER, Mr. ROBERTS of South Dakota, Mrs. COLLINS of Illinois, Mr. KOGOVSEK, Mr. BAILEY of Missouri, Mr. LAGOMARSINO, Mr. GUYER, Mr. ROBERT W. DANIEL, JR., Mr. COLLINS of Texas, Mr. WHITEHURST, Mr. BLILEY, Mr. FORSYTHE, Mr. LUNGREN, Mr. GOLDWATER, and Mr. FRENZEL) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To repeal the family rental home business tax; to amend the Internal Revenue Code of 1954 with respect to the deduction of certain expenses in connection with the business use of homes and the rental of residences to family members, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF SECTION 280A.

(a) BUSINESS USE OF HOME.—Subparagraph (A) of section 280A(c)(1) of the Internal Revenue Code of 1954 (relating to certain business use) is amended to read as follows:

"(A) a principal place of business for any trade or business of the taxpayer."

(b) USE OF RESIDENCE BY FAMILY MEMBER.—Subsection (d) of section 280A of such Code (relating to use as residence) is amended—

(1) by striking out ", or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person" in paragraph (2), and

(2) by striking out "to a person other than a member of the family (as defined in section 267(c)(4)) of the taxpayer" in paragraph (3).

(c) REPAIR AND MAINTENANCE OF DWELLING UNIT.—Notwithstanding any ruling, proposed regulation, or regulation to the contrary, a dwelling unit shall not be treated as used by the taxpayer for personal purposes under section 280A on a day on which the taxpayer is engaged in repair or maintenance work on the dwelling unit on a substantially full-time basis because other individuals on the premises on that day who are capable of working do not work on the unit on a substantially full-time basis.

SEC. 2. APPLICATION OF SECTION 1.

The amendments made by subsections (a) and (b) of section 1 of this Act and subsection (c) of such section shall apply with respect to all taxable years to which section 280A of the Internal Revenue Code of 1954 applies.

97TH CONGRESS
1ST SESSION

H. R. 1410

To amend the Internal Revenue Code of 1954 with respect to the deduction of certain expenses in connection with the business use of homes and the rental of residences to family members.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 28, 1981

Mr. MARRIOTT introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the deduction of certain expenses in connection with the business use of homes and the rental of residences to family members.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF SECTION 280A.

(a) BUSINESS USE OF HOME.—Subparagraph (A) of section 280A(c)(1) of the Internal Revenue Code of 1954 (relating to certain business use) is amended to read as follows:

"(A) a principal place of business for any trade or business of the taxpayer".

(b) USE OF RESIDENCE BY FAMILY MEMBER.—Subsection (d) of section 280A of such Code (relating to use as residence) is amended—

(1) by striking out ", or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person" in paragraph (2), and

(2) by striking out "to a person other than a member of the family (as defined in section 267(c)(4)) of the taxpayer" in paragraph (3).

SEC. 2. APPLICATION OF SECTION 1.

The amendments made by subsections (a) and (b) of section 1 of this Act shall apply with respect to all taxable years to which section 280A of the Internal Revenue Code of 1954 applies.

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97TH CONGRESS
1ST SESSION

H.R. 4071

To amend the Internal Revenue Code of 1954 to provide that the limitations of section 280A will not apply to rentals under shared equity financing arrangements.

IN THE HOUSE OF REPRESENTATIVES

JULY 8, 1981

Mr. DUNCAN introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to provide that the limitations of section 280A will not apply to rentals under shared equity financing arrangements.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (d) of section 280A of the Internal Revenue Code of 1954 (relating to disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.) is amended by adding at the end thereof the following new paragraph:

"(4) SHARED EQUITY FINANCING ARRANGEMENTS.—

"(A) IN GENERAL.—In the case of any taxpayer who has an interest in a dwelling unit under a shared equity financing agreement, subsections (c)(5) and (e) shall not apply to deductions attributable to the rental of such dwelling during periods during which the dwelling unit is rented in accordance with such agreement.

"(B) SHARED EQUITY FINANCING AGREEMENT.—For purposes of subparagraph (A), the term 'shared equity financing agreement' means an agreement under which—

"(i) 2 or more persons acquire interests in a dwelling unit, and

"(ii) 1 or more of the persons holding one of such interests—

"(I) are entitled to occupy the dwelling unit for use as a principal residence, and

"(II) are required to pay the other persons holding ownership interests in the dwelling unit a rental which (after taking into acount the occupant's ownership interest) is a fair rental."

(b) The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1980.

Summary and Description

PRESENT LAW

In general

Section 280A, enacted as part of the Tax Reform Act of 1976, disallows the deduction of certain expenses incurred in connection with the use of the taxpayer's home in a trade or business or income producing activity or in connection with the rental of vacation homes and other residential real estate. The restrictions in section 280A were enacted to replace vague standards on which courts and the Internal Revenue Service differed with more definitive, objective statutory tests for determining the deductibility of expenses. Section 280A applies to individuals trusts, estates, partnerships and electing small business corporations.

The deductions under sections 163, 164 and 165 for interest, certain taxes, and casualty losses attributable to a taxpayer's personal residence are not affected by section 280A.

Business use of the home

Unless specifically expected from section 280A and otherwise allowable, no deductions are allowed with respect to a dwelling unit because of its connection to a taxpayer's trade or business or income producting activities, if the taxpayer uses the dwelling as a residence. One exception to the general rule of section 280A allows deductions attributable to a portion of the taxpayer's residence which is exclusively used on a regular basis as a taxpayer's principal place of business.

On August 7, 1980, proposed Treasury Regulations under section 280A were published in the Federal Register (45 Fed. Reg. 52399). The proposed regulations would define "the taxpayer's principal place of business" as the principal place of the taxpayer's overall business activity. A taxpayer would have only one principal place of business regardless of the number of business activities in which the taxpayer is engaged. The proposed regulations do not follow the U.S. Tax Court decision in *Curphey* v. *Commissioner*, 73 T.C. 766 (1980), which allowed a hospital-employed dermatologist to deduct expenses for a home office which was the principal place of business for his real estate rental business.

Personnel use of residence

Section 280A, in general, limits the amount of a taxpayer may deduct for expenses attributable to the rental of a dwelling unit, in many cases a vacation home, if the taxpayer uses the unit for personal purposes in excess of a specified period of time during a taxable year. This limitation applies only if the taxpayer's use of the dwelling unit for personal purposes during a taxable year exceeds the greater of fourteen days or ten percent of the number of the days during the year for which the unit is rented. If a taxpayer exceeds these personal use limitations, deductions attributable to the rental activity are limited to the amount by which the gross income derived from the rental activitiy exceeds the deductions otherwise allowable without regard to such rental activities (*e.g.*, interest and certain taxes).

In the case of an individual or subchapter S corporation, if the taxpayer uses a dwelling for personal purposes during a taxable year (whether or not the personal use exceeds the personal use limitations), the amount deductible with respect to the expenses attributable to the rental of the dwelling is limited to a portion of such expenses, based on the number of days the dwelling is rented at a fair rental compared to the total number of days the dwelling is used during the taxable year.

Family rentals and rentals to co-owners.—The taxpayer generally is deemed to have used a dwelling unit for personal purposes for a day if, for any part of the day, the unit is used for personal purposes by (1) the taxpayer or any other person who owns an interest in the home; (2) the brothers and sisters, spouse, ancestors, or lineal descendants of the taxpayer or other owners; (3) any individual who uses the unit under a reciprocal arrangement (whether or not a rental is charged); or (4) any other individual who uses the dwelling unit during a day unless a fair rental is charged.

The Revenue Act of 1978 amended section 280A to provide that the use of a dwelling unit as a taxpayer's principal residence (within the meaning of section 1034) is not to be treated as personal use in determining whether the limitations of section 280A apply to deductions attributable to a "qualified rental period" which immediately precedes or follows a period of use as the taxpayer's principal residence. Under section 280A, a qualified rental period generally is a period of 12 or more consecutive months during which the unit is rented to a person other than a family member, or held for rental, at a fair rental.

Repairs and maintenance.—Section 280A also provides that the Secretary of the Treasury must prescribe by regulation the circumstances under which use of a

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dwelling unit for repairs and annual maintenance will not constitute personal use of the unit. Under the proposed regulations published on August 7, 1980, an individual would have to be engaged in repair or maintenance work for a day on a substantially full-time basis, i.e., the lesser of eight hours or two-thirds of the time present on the premises, to qualify the day's use of the unit as use for repairs and maintenance. The proposed regulations would require that all individuals on the premises on a day must be engaged in work on the unit on a substantially full-time basis, to avoid the day being treated as one of personal use. However, the proposed regulations would disregard the presence of individuals, such as small children, who are incapable of working.

ISSUES

The principal issues are, (1) whether business expenses attributable to the use of a portion of a taxpayer's residence as the principal place of business for a separate, secondary business of the taxpayer, should be subject to the general rule of section 280A disallowing deductions for such expenses, (2) whether rental of a taxpayer's principal residence or another dwelling to a family member at a fair rental price should be treated in the same manner as a rental to an unrelated party, (3) whether regulations should treat a taxpayer as having used a dwelling for personal purposes if the taxpayer spends a normal working day repairing or maintaining the dwelling while other persons, who are capable of working, use the dwelling for personal purposes, and (4) whether rental to a co-owner at a fair rental should be treated the same as a rental to an unrelated party where the co-owner uses the dwelling as his principal residence.

EXPLANATION OF BILLS AND EFFECTIVE DATES

1. H.R. 588—Mr. Roybal

Under the bill, section 280A(d)(2) would be amended to provide that the use of a dwelling by a member of the taxpayer's family (or the family of any other person with an interest in the dwelling) does not constitute a personal use of the dwelling by the taxpayer if the family member pays a fair rental for the dwelling, is at least 60 years old, or is permanently and totally disabled.

Under section 280A(d)(3), a taxpayer's use of a dwelling as a principal residence is not considered personal use for any period immediately before or after a "qualified rental period." The bill would provide that a "qualified rental period" is a period of 12 or more months (or less than 12 months if the dwelling is sold or exchanged at the end of the period) for which a taxpayer's principal residence is rented or is held for rental at a fair rental, regardless of whether the dwelling is rented to a member of the taxpayer's family or an unrelated person.

The provisions of H.R. 588 would apply to taxable years beginning after December 31, 1980.

2. H.R. 890—Mr. Martin

Under the provisions of H.R. 890, the effective date of section 280A would be amended to postpone the application of section 280A until taxable years beginning after December 31, 1981.

3. H.R. 1177—Messrs. Pepper and Rousselot

The provisions of H.R. 1177 would provide two amendments to section 280A that would treat fair-market rentals to family members in the same way as rentals to unrelated parties, thereby allowing deductions for expenses attributable to such rentals. Section 280A(d)(2) would be amended so that the use of a dwelling by a member of the family of either the taxpayer or any other person with an interest in the dwelling would not be considered the personal use of the dwelling by the taxpayer if the dwelling is rented to the family member at a fair rental.

Under section 280A(d)(3), a taxpayer's use of a dwelling as a principal residence is not considered personal use for any period immediately before or after a "qualified rental period." The bill would provide that a "qualified rental period" is a period of 12 or more months (or less than 12 months if the dwelling is sold or exchanged at the end of the period) for which a taxpayer's principal residence is rented or is held for rental at a fair rental, regardless of whether the dwelling is rented to a member of the taxpayer's family or an unrelated person.

The provisions of H.R. 1177 would apply to taxable years beginning after December 31, 1975, the taxable years to which section 280A applies.

4. H.R. 1290—Messrs. Bafalis and Frenzel

This bill contains three amendments to section 280A and a provision relating to rulings and regulations of the Internal Revenue Service concerning use of a dwelling for maintenance and repair.

The bill would amend section 280A(c)(1)(A) to provide that the general limitation on deductions in section 280A(a) shall not apply to expenses allocable to the regular and exclusive use of a portion of a taxpayer's residence as a principal place of business for any trade or business of the taxpayer. Thus, a taxpayer could have a distinct principal place of business for each separate trade or business and could deduct expenses attributable to the use of a residence as the principal place of business for one or more such businesses, provided the regular and exclusive use requirements are met.

Two amendments would treat fair-market rentals to family members in the same way as rentals to unrelated parties, thus allowing deductions for expenses attributable to such rentals. Section 280A(d)(2) would be amended so that the use of a dwelling by a member of the family of either the taxpayer or any other person with an interest in the dwelling would not be considered the personal use of the dwelling by the taxpayer if the dwelling is rented to the family member at a fair rental.

Under section 280A(d)(3), a taxpayer's use of a dwelling as a principal residence is not considered personal use for any period immediately before or after a "qualified rental period." The bill would provide that a "qualified rental period" is a period of 12 or more months (or less than 12 months if the dwelling is sold or exchanged at the end of the period) for which a taxpayer's principal residence is rented or is held for rental at a fair rental, regardless of whether the dwelling is rented to a member of the taxpayer's family.

The bill also would provide that, notwithstanding any ruling, proposed regulation, or regulation to the contrary, a dwelling would not be treated as used for the personal purposes of the taxpayer on a day the taxpayer repairs or maintains the dwelling on a substantially full-time basis because other persons, who are on the premises and who are capable of working, do not work on a substantially full-time basis.

The provisions of H.R. 1290 would apply to taxable years beginning after December 31, 1975, the taxable years to which section 280A applies.

5. H.R. 1410—Mr. Marriott

The bill would amend section 280A(c)(1)(A) to provide that the general limitation on deductions in section 280A(a) shall not apply to expenses allocable to the regular and exclusive use of a portion of a taxpayer's residence as a principal place of business for any trade or business of the taxpayer. Thus, a taxpayer could have a distinct principal place of business for each separate trade or business and could deduct expenses attributable to the use of a residence as the principal place of business for one or more such businesses, provided the regular and exclusive use requirements are met.

The bill would also amend section 280A to provide that fair-market rentals to family members will be treated in the same manner as rentals to unrelated persons. Section 280A(d)(2) would be amended to provide that fair-market rentals to members of the taxpayer's family (or the family of any other person with an interest in the dwelling) will not be considered the personal use of the dwelling by the taxpayer. Section 280A(d)(3) would be amended to provide that a "qualified rental period" includes a period for which a dwelling is rented at a fair rental, regardless of whether the dwelling is rented to a member of the taxpayer's family or an unrelated person.

The provisons of H.R. 1410 would apply to taxable years beginning after December 31, 1975, the taxable years to which section 280A applies.

6. H.R. 4071—Mr. Duncan

Under H.R. 4071, the limitations of section 280A(c)(5) and 280A(e) on the deduction of expenses attributable to the rental of a dwelling would not apply to deductions attributable to the rental of a dwelling under a shared equity financing agreement. A shared equity financing agreement would be defined as an agreement under which two or more persons acquire interests in a dwelling and one or more of the owners occupies the dwelling as a personal residence and pays the nonresident owners a fair rental for the dwelling (after taking into account the occupant's ownership interest).

However, the use of the dwelling under a shared equity financing agreement would continue to constitute the personal use of the dwelling by each of the persons with an ownership interest in the dwelling. Therefore, such dwelling would be considered as being used for personal purposes by each of such persons and generally would be considered as used as a residence by each of such persons. Therefore,

the limitations of section 280A would apply to limit the deductibility of expenses attributable to all other business uses of such dwelling by the co-owners.

The provisons of H.R. 4071 would apply to taxable years beginning after December 31, 1980.

STATEMENT OF HON. L. A. "SKIP" BAFALIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman, I appreciate the opportunity to address the Select Revenue Measures Subcommittee in support of H.R. 1290, which would correct the overzealousness of the Internal Revenue Service in interpreting Section 280A of the Internal Revenue Code.

It is particularly disconcerting that the IRS would attempt to use its rule-making authority to overrule a tax court decision, more particularly the decision in *Curphey* v. *Commissioner*.

As the members of this subcommittee well recall, when we enacted 280A in the 1976 Tax Reform Act, we sought to clarify the deduction of certain expenses incurred in the use of a taxpayers' home in a trade or business or in an income-producing activity.

However, I am certain none of us expected the IRS to go as far as it did in defining "office in a home."

It was obvious to the members of this committee that for an office in a home to be deductable, it should be the principle office for that business. However, I don't recall any discussion on the part of the members of this committee to carry that definition to the extreme the IRS did when it said not only should that home office be the principal place of business, but that business must also be that taxpayer's principal business.

In these days of high inflation when so many Americans are forced to take second jobs—and when so many of those jobs require an office in the home—it seems to me, and to the 39 other members of Congress who have joined as cosponsors of H.R. 1290, that the IRS is just going too far.

However, this isn't the only problem in Section 280A which H.R. 1290 addresses.

This legislation, identical to S. 31 introduced by our former colleague Bill Armstrong of Colorado, also would correct the situation with respect to rental to a relative and the definition of personal use, both of which desperately need clarification.

The effect of including the language ", or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person" has been to penalize those taxpayers who rent property to a close relative, such as an elderly mother even though the relative is paying fair market rent. Instead of encouraging individuals to place their elderly parents in an institution, we should encourage them to provide shelter for aging parents in a home or condominium which they might be fortunate enough to own.

In addition, H.R. 1290 seeks to correct the overzealous approach of the IRS in its definition of personal use of a rental home.

If I am fortunate enough to own a vacation home which is rented part of the time and I visit the property to take care of needed repairs and maintenance, there is no reason why my children, if they accompany me, must also work or the day will be counted as personal use.

That's not the kind of reasonable interpretation the Congress intended when it directed the formulation of regulations regarding personal use of rental property.

While the exchange of vacation homes and time-sharing arrangements are clearly to be barred from receiving rental property tax treatment, the proposed IRS regulations are extreme and put a further burden on the already depressed housing industry.

Mr. Chairman, I should also like to bring to the subcommittee's attention another problem with Section 280A, one not covered in my bill, H.R. 1290, but which I think merits your consideration.

And that is the inequity created by section 280A(d)(2)(A) where there is a market rate rental of a dwelling unit by a taxpayer to a co-owner of the unit.

If allowed to remain, this inequity will eliminate a creative financing arrangement which has been developed to facility home purchases in the skyrocketing markets in the San Francisco Bay area and elsewhere.

Under this financing arrangment, an investor with capital to invest in real estate purchases a residency as a tenant-in-common with a person who desires to use the house as his home. The investor and the homeowner share ownership of the residence in some ratio which reflects their respective investment in the property.

During the co-tenancy period, the investor's interest in the residence is leased to the homeowner at market rental rates.

But section 280A(d)(2)(A) appears to preclude that.

Again, Mr. Chairman, I appreciate the opportunity afforded by this subcommittee to testify in behalf of H.R. 1290 and urge your favorable consideration of this much-needed legislation.

Thank you.

THE ARTERY ORGANIZATION, INC.,
Chevy Chase, Md., November 2, 1981.

Re H.R. 4071—Revision to section 280A.

HOUSE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

(Attention John J. Salmon, Esq., Chief Counsel).

DEAR MR. SALMON: We are writing to urge that the subcommittee support H.R. 4071, which would make certain limitations of section 280A of the Internal Revenue Code inapplicable to deductions attributable to the rental of a dwelling unit under a shared equity financing agreement. We believe that H.R. 4071 would enable a substantial number of people to acquire equity in their own homes for the first time.

The Artery Organization has been building and developing housing, primarily in the Washington, D.C. area, for over twenty years. During this time, we have built or developed over 10,000 housing units in a wide variety of projects, ranging from single family detached and townhouse developments, to apartment projects providing housing for federally assisted low-income and elderly residents, to luxury high-rise apartment projects. Our goal has been to provide quality, affordable housing for a diverse group of people; and to adapt our programs to meet their changing needs. Most recently, we have become involved in condominium conversion projects to meet the growing demand for owner-occupied apartment housing.

One of the primary goals in our condominum conversion projects has been to preserve the character of the existing communities by minimizing displacement of existing tenants. We have worked closely with tenant groups in developing programs to meet the diverse needs of existing residents. Our programs have included resident purchase discounts, favorable resident financing packages, relocation assistance payments, and long and short term rental programs to enable some residents to remain as tenants. We have achieved a great deal of success; in our first major condominium conversion, 35% of the original tenants have been able to purchase apartments and over 50 percent of the original tenants will remain at the project as either owners or renters. However, these statistics could be even more impressive if section 280A were amended as proposed in H.R. 4071.

As our staff has worked with tenant groups in our condominum projects, it has become clear that there are many residents who wish to purchase their apartments but cannot afford to do so, usually because they cannot afford the required down-payment or because they cannot qualify for the necessary financing. To address this problem, we are attempting to develop a co-purchase program through which an existing tenant would purchase an individed ownership interest in his or her unit, and an unrelated investor would purchase the remaining undivided ownership interest and lease it to the tenant at a fair market rent. As we understand it, this type of co-purchase arrangement comes within the definition of a "shared equity financing arrangement" set forth in H.R. 4071. We have found that this program is attractive to many potential investors because a tenant who is also a co-owner is likely to maintain the unit in a better condition than a tenant with no ownership interest.

The only problem with the program is that investors are unwilling to participate because section 280A apparently prohibits the investor from taking income tax deductions to which he would be entitled if his co-purchaser were not the tenant. Under section 280A(d), the investor is deemed to use the apartment unit for personal purposes (which results in the investor's being deemed to use the apartment as his own residence) if the apartment is used by "any other person who has an interest in such unit". Because the unit is deemed to be used for personal purposes by the investor, the investor's interest in the unit is not treated as rented at a fair rental, even if the tenant pays a fair rental to the investor. The result under section 280A(e) is that the investor may only deduct expenses which would be allowable whether he or not his interest in the unit was rented (typically interest and real estate taxes). Most significantly, the investor is prohibited from taking a depreciation deduction with respect to his interest.

In other words, under section 280A an investor who purchases a condominium unit with another investor, and leases his interest in the unit to a tenant at a fair rental value, is entitled to depreciation and other "business" deductions with respect to his interest in the unit, unless the other investor happens to be the tenant who pays the fair market rental. We believe that there is no rational basis or valid policy rationale for this distinction, and the practical result is to force displacement of tenants who would otherwise have an opportunity to purchase an ownership interest in their homes.

As we understand the effect of H.R. 4071, this result would be changed to allow an investor in a copurchase program to take the same deductions he would be entitled to if he invested alone or with another investor who did not live in the apartment. Accordingly, we urge your support for enactment of H.R. 4071, at the earliest possible time.

Very truly yours,

ALAN GELLER,
Executive Vice President.

Submitted by David C. Bahls, Ann Arbor, Mich.

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Home Office Deductions: May a Taxpayer Have More Than One Principal Place of Business?

Section 280A of the Internal Revenue Code[1] establishes the conditions under which taxpayers may deduct expenses incurred to maintain offices in their homes. Congress enacted this provision to enable taxpayers, the Internal Revenue Service (IRS), and the courts to distinguish objectively between deductible business expenses and nondeductible personal living expenses, and to limit excessive deductions.[2] The section furthers these goals by generally prohibiting

1. Tax Reform Act of 1976, Pub. L. No. 95-455, § 601, 90 Stat. 1520 (codified at I.R.C. § 280A). Section 280A provides in part:

(a) GENERAL RULE. — Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an electing small business corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

(b) EXCEPTION FOR INTEREST, TAXES, CASUALTY LOSSES, ETC. — Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

(c) EXCEPTION FOR CERTAIN BUSINESS OR RENTAL USE; LIMITATION ON DEDUCTIONS FOR SUCH USE. —

(1) CERTAIN BUSINESS USE. — Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis —

(A) as the taxpayer's principal place of business,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.

(5) LIMITATION ON DEDUCTIONS. — In the case of a use described in paragraph (1) . . . the deductions allowed under this chapter for the taxable year by reason of being attributed to such use shall not exceed the excess of —

(A) the gross income derived from such use for the taxable year, over

(B) the deductions allocable to such use which are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used.

This Note considers only the deduction authorized by § 280A(c)(1)(A) — the "principal place of business" exception.

2. *See* S. REP. NO. 938, 94th Cong., 2d Sess. 9-10, 147, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3446, 3579-80 [hereinafter cited as SENATE REPORT]; H.R. REP. NO. 658, 94th Cong., 1st Sess. 10, 160, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2987, 2905, 3053-54. When Senator Long, Chairman of the Senate Finance Committee, introduced this section on the floor of the Senate, he stated:

> While in theory there is nothing wrong with appropriate deductions for business or investment expenses, in practice it is often extremely difficult to allocate between deductible business expenses and nondeductible personal expenses. The result is that many people are deducting excessive amounts, and the bill places strict limits on these deductions.

122 CONG. REC. 18,542 (1976).

Expenses incurred in a taxpayer's trade or business or in the production of income are generally deductible. I.R.C. §§ 162, 212. However, "[e]xcept as otherwise expressly provided . . . no deduction shall be allowed for personal, living, or family expenses." I.R.C. § 262. Congress allows taxpayers to deduct certain personal expenses for unexpected occurrences, such as casualty losses, I.R.C. § 165(c)(3), and large medical bills, I.R.C. § 213, and for behav-

deductions for trade or business expenses[3] attributable to home offices,[4] and specifying a limited number of exceptions. One of those exceptions authorizes home office deductions where the taxpayer uses part of his home "exclusively . . . on a regular basis" as his "principal place of business."[5]

Although the phrase "principal place of business" seems relatively straightforward, it has created interpretative difficulties. The IRS defines "principal place of business" as the single location from which the taxpayer conducts the bulk of his total business activity, regardless of whether he engages in several separate businesses.[6] In *Curphey v. Commissioner*,[7] the Tax Court rejected this approach in favor of a broader definition. The taxpayer in *Curphey* managed several condominiums in addition to working full time at a hospital and deducted expenses attributable to a home office that he used exclusively on a regular basis to manage the condominiums.[8] The IRS argued that Curphey could have only one principal place of business

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ior that the legislature wishes to encourage, such as charitable contributions, I.R.C. § 170. Congress also permits taxpayers to deduct certain state and local taxes, I.R.C. § 164. For a general discussion of this area, see M. CHIRELSTEIN, FEDERAL INCOME TAXATION 140-53 (2d ed. 1979).

3. Typically, these expenses include an allocable portion of the home depreciation, maintenance, utility, and insurance expenses. SENATE REPORT, *supra* note 2, at 144, [1976] U.S. CODE CONG. & AD. NEWS at 3577.

4. I.R.C. § 280A(a).

5. I.R.C. § 280A(c)(1)(A).

Section 280A also allows the home office deductions for two other types of offices: a place of business normally used by "patients, clients, or customers," or a separate structure not attached to the dwelling unit. I.R.C. § 280A(c)(1). In each case, the home office must be "exclusively used on a regular basis" for business purposes. In the case of an employee, the home office must be exclusively used "for the convenience of his employer." I.R.C. § 280A(c)(1). Congress also limited the amount that a taxpayer could deduct. The taxpayer may deduct the amount of gross income generated by the business use of the home less the amount of deductions otherwise allowed by the Code for the home, such as property taxes, I.R.C. § 164, and mortgage interest payments, I.R.C. § 163. I.R.C. § 280A(c)(5). For the text of these provisions, see note 1 *supra*.

There are circumstances in which a taxpayer may choose not to take the home office deduction even if his expenses qualify under § 280A. That part of the home to which expenses are allocated as a business office does not qualify for nonrecognition of gain upon the sale of the home. I.R.C. § 1034. Therefore, any gain realized for that portion of the house would have to be currently recognized. *See generally* Priv. Rul. 7950003, IRS LETTER RUL. (CCH) Book 7, Fiche 1; Lubell, *The Home Office Deduction: Is it Worth It?*, 56 TAXES 528 (1978). Presumably the same is true for I.R.C. § 121, the one-time exclusion of gain from the sale of a principal residence by an individual who has attained age 55.

6. *See* Curphey v. Commissioner, 73 T.C. 766, 776 (1980); Proposed Treas. Reg. § 1.280A-2(b)(2) (Aug. 7, 1980) ("[A] taxpayer may have only one principal place of business regardless of the number of business activities in which the taxpayer may be engaged."); Priv. Rul. 8048014, [1980] IRS LETTER RUL. (CCH) Fiche 50; Priv. Rul. 8048080, [1980] IRS LETTER RUL. (CCH) Fiche 50; Priv. Rul. 8030025, [1980] IRS LETTER RUL. (CCH) Fiche 31; Priv. Rul. 8030024, [1980] IRS LETTER RUL. (CCH) Fiche 31.

7. 73 T.C. 766 (1980).

8. 73 T.C. at 767-68. The Tax Court also determined that management of the rental property constituted a business under § 280A. 73 T.C. at 775.

even if he engaged in more than one business.[9] The Service contended that the hospital was Curphey's principal place of business because he spent more time and earned a greater portion of his income there.[10] The Tax Court, however, held that section 280A authorizes deductions for a home office that is the principal place of any of a taxpayer's businesses.[11] Because Curphey's home office was the principal place of his rental business, section 280A would not prevent him from deducting the expenses incurred to maintain that office. The IRS does not acquiesce in the Tax Court's decision, and has proposed regulations that adopt the overall business activity interpretation.[12]

This Note argues that the Tax Court's more liberal interpretation is correct because it more nearly reflects Congress's intent. Part I seeks a basis for preferring one of the competing interpretations in the text of section 280A and in the section's legislative history, but finds none. Looking, of necessity, to the purposes that Congress sought to advance with section 280A, Part II argues that those purposes do not demand a restrictive reading of "principal place of business." Such a reading, moreover, would undermine fundamental and longstanding congressional tax policies. In the absence of a more explicit statement of congressional intent, this policy analysis provides a reasonable basis for rejecting the IRS's definition and for concluding that home office expenses are deductible if the office in question is the principal place of any of the taxpayer's businesses.

I

Although Congress excepted home offices that serve as a taxpayer's "principal place of business" from section 280A's general rule of nondeductibility, it did not define this phrase when it enacted the section. Because Congress apparently did not consider how this provision would apply to taxpayers engaged in more than one busi-

9. 73 T.C. at 775-76.

10. 73 T.C. at 775-76.

11. 73 T.C. at 776-77.

12. Proposed Treas. Reg. § 1.280A-2(b)(2) (Aug. 7, 1980).

After these proposed regulations were announced, Congress forbade the IRS from using public funds to enforce regulations that determine the taxpayer's principal place of business under § 280A. Appropriation — Fiscal Year 1981, Pub. L. No. 96-369, § 123, 94 Stat. 1351 (1980). Senator William L. Armstrong has since proposed S.31, 97th Cong., 1st Sess. (1981), which, in part, would clarify § 280A by explicitly allowing a deduction, subject to certain limitations, for the expenses incurred by a taxpayer in maintaining a home office which is the principle place of *any* business, including a secondary business. In a letter to Senator Armstrong dated July 13, 1981, the Assistant Secretary for Tax Policy indicated that this amendment was unnecessary since the Treasury now intends to propose new regulations providing for such a result. *See* [1981] 9 FED. TAXES (P-H) ¶ 55,421, at 55,236. At this writing, new proposed regulations have not been issued.

ness,[13] the statutory language does not indicate whether section 280A refers to the principal place of all of a taxpayer's business activity or to the principal place of any specific business.[14] Despite section 280A's lack of clarity on this point, the IRS argues that the statute's language favors its approach. Specifically, the Service points out that Congress authorized deductions for expenses incurred in maintaining a principal *place* of business rather than principal *places*.[15] But "words importing the singular include and apply to several persons, parties, or things" in all acts of Congress, unless the context otherwise requires.[16] The IRS argues further that because Congress authorized deductions for three types of home offices,[17] it is an "obvious conclusion" that if the office is not the taxpayer's "principal place of business," a deduction is allowable only if one of the other provisions applies.[18] This argument, however, is at least as circular as it is obvious. Both its premise and its conclusion assume that a taxpayer may apply the exception only once, and the mere presence of other exceptions does not justify that assumption.

The definitional problem is compounded by the fact that Congress has not used the phrase "principal place of business" in any other section of the Code in a way that elucidates the meaning of section 280A. Lacking explicit textual support for its position, the

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13. The issue was raised in a letter to Congress, but apparently not acted upon. The writer stated:

> Let me also raise a third point which I believe should be clarified in the committee report. Section 280(c)(1)(a) [sic] applies to the taxpayer's "principal place of business." It is my assumption that this relates to the business whose income is being taxed and not to the major source of income of the individual.

Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance, 94th Cong., 2d Sess. 3220 (1976) (letter from Roy Slade, director, Corcoran Gallery of Art).

Congress debated the Tax Reform Act on the following dates: Dec. 3 & 4, 1975, (considered in and passed by the House); June 16-18, 21-25, 28-30, July 1, 20-23, 26-30, Aug. 3-6, 1976 (House and Senate agreed to conference report that resolved amendments in disagreement). *See* 121 CONG. REC. 35,458 (1975); 122 CONG. REC. 17,454 (1976).

14. *See* I.R.C. § 280A. Other sections of the Code that use the phrase "principal place of business" refer to the headquarters or main office of a single corporation or tax preparation business. *See* I.R.C. § 819A(b) (contiguous country branches of domestic life insurance companies); I.R.C. § 5113(b) (exemption of sales by liquor stores operated by states, political subdivisions, etc.); I.R.C. § 6038(a) (information with respect to certain foreign corporations); I.R.C. § 6091(b) (place for filing returns or other documents); I.R.C. § 7407(a), (c) (action to enjoin income tax preparers); I.R.C. § 7482(b) (courts of review; venue).

15. *See* Priv. Rul. 8048080, [1980] IRS LETTER RUL. (CCH) Fiche 50; Priv. Rul. 8048014, [1980] IRS LETTER RUL. (CCH) Fiche 50; Priv. Rul. 8030025, [1980] IRS LETTER RUL. (CCH) Fiche 31; Priv. Rul. 8030024, [1980] IRS LETTER RUL. (CCH) Fiche 31.

16. 1 U.S.C. § 1 (1976) (cross referenced from I.R.C. § 7701(d)(1)(1)). *Cf.* Treas. Reg. § 1.368-2(h) (1960) ("As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires . . . the singular includes the plural.").

17. *See* note 1 *supra*.

18. Brief for Respondent at 14-15, Curphey v. Commissioner, 73 T.C. 766 (1980). Priv. Rul. 8048080, [1980] IRS LETTER RUL. (CCH) Fiche 50; Priv. Rul. 8048014, [1980] IRS LETTER RUL. (CCH) Fiche 50; Priv. Rul. 8030025, [1980] IRS LETTER RUL. (CCH) Fiche 31; Priv. Rul. 8030024, [1980] IRS LETTER RUL. (CCH) Fiche 31.

IRS has relied by analogy on decisions interpreting section 162(a)(2),[19] which authorizes the deduction of "ordinary and necessary . . . traveling expenses . . . [incurred] while away from home in the pursuit of a trade or business."[20] The Service invokes this analogy because, for the purposes of section 162, a taxpayer's home "is [usually] considered to be located at his principal or regular place of business or employment."[21] The IRS argues that the criteria used to determine a taxpayer's tax home under section 162 should also be used to designate his "principal place of business" under section 280A.[22] Implicit in these criteria is an assumption that a taxpayer may have only one principal place of business and, therefore, only one tax home,[23] regardless of how many businesses he has.[24]

There are several reasons why courts should not rely on cases interpreting section 162(a)(2) to interpret section 280A's "principal place of business" requirement. First, the tax "home" relevant to section 162 includes the entire city or general area in which a business is located,[25] while a taxpayer's "principal place of business" under section 280A is related to a specific situs or building.[26] Second, these sections address different types of tax problems. Congress adopted section 162(a)(2) to aid taxpayers whose businesses require that they travel to another city and incur additional living expenses.[27] Although these expenses generally would be classified as

19. 73 T.C. at 776.

20. I.R.C. § 162(a), 162(a)(2). Travel expenses generally include transportation expenses, meals, and lodging.

21. Rev. Rul. 71-247, 1971-1 C.B. 54, 54. *See* Coombs v. Commissioner, 608 F.2d 1269, 1274 (9th Cir. 1979); Frank v. United States, 577 F.2d 93, 97 (9th Cir. 1978); Markey v. Commissioner, 490 F.2d 1249, 1253 (6th Cir. 1974); Daly v. Commissioner, 72 T.C. 190, 195 (1979), *revd.*, 631 F.2d 351 (4th Cir. 1980). *But see* Six v. United States, 450 F.2d 66, 69 (2d Cir. 1971); Burns v. Gray, 287 F.2d 698, 700 (6th Cir. 1961).

22. *See* Brief for Respondent at 11-14, Curphey v. Commissioner, 73 T.C. 766 (1980). The factors used to determine which area is the taxpayer's home under § 162(a)(2) are (1) the total time ordinarily spent in performing duties in each area; (2) the degree of the individual's activity in each area, and (3) the relative significance of his financial return from each area. *See* Markey v. Commissioner, 490 F.2d 1249, 1252 (6th Cir. 1974); IRS Publication No. 17 at 67, 1 IRS PUBLICATIONS (CCH) 501, 569 (1980).

23. *See* Markey v. Commissioner, 490 F.2d 1249 (6th Cir. 1978); Curphey v. Commissioner, 73 T.C. 766 (1980); Montgomery v. Commissioner, 64 T.C. 175 (1975), *affd.*, 532 F.2d 1088 (6th Cir. 1976); Sherman v. Commissioner, 16 T.C. 332 (1951).

24. *See generally* Benson v. Commissioner, 27 T.C.M. (CCH) 1555, 1557 (1968); Dorsky v. Patterson, 59-1 U.S. Tax Cas. (CCH) ¶ 9135, at 71,189 (D. Alaska 1958); Stairwalt v. Commissioner, 11 T.C.M. (CCH) 902, 903 (1952); Sherman v. Commissioner, 16 T.C. 332, 337 (1951).

25. *See* Curphey v. Commissioner, 73 T.C. at 776; IRS, DEPT OF THE TREAS., PUB. NO. 463, TRAVEL, ENTERTAINMENT AND GIFT EXPENSES 2 (1980).

26. The taxpayer's home office is in his place of residence — a particular building. The *Curphey* court rejected the application of the § 162(a)(2) criteria for this reason. 73 T.C. at 776.

27. *See* Daly v. Commissioner, 72 T.C. at 195; Kroll v. Commissioner, 49 T.C. 557, 562 (1968); Benson v. Commissioner, 27 T.C.M. (CCH) 1555, 1557 (1968).

nondeductible personal expenses,[28] Congress concluded that duplicative costs incurred to further a business should be deductible.[29] Section 280A, on the other hand, represents an attempt to distinguish between business and personal expenses to prevent taxpayers from deducting personal expenditures.[30] Home office expenses are deductible because of their inherent business nature, rather than because these expenses duplicate costs otherwise incurred by the taxpayer. The IRS's single principal place of business requirement may be justified under section 162(a)(2) as a reasonable means to determine whether the taxpayer has incurred duplicative expenses. But section 280A has no duplication requirement, and the analogy relied on by the IRS is, therefore, inapposite.

Part I thus finds no basis in section 280A's language, in explicit congressional statements, or in analogies to other Code sections for preferring either the IRS's "total business" interpretation or the Tax Court's more liberal one. Part II looks for other evidence that may illuminate Congress's intent.

II

To choose between the alternative constructions of "principal place of business," courts should examine how each interpretation comports with the purposes of section 280A, and adopt the one that best satisfies congressional intent.[31] Congress enacted section 280A to "curb the widespread abuses"[32] associated with home office deductions — to prevent taxpayers from deducting predominantly personal expenses under the guise of business expenses.[33] Although this purpose would favor a restrictive reading of section 280A's exceptions, another fundamental tax policy — authorizing the deduction of legitimate business expenses — also underlies the section. It is, therefore, essential that courts strike a balance between these competing policies. Part II argues that only the Tax Court's interpretation guarantees the deductibility of legitimate business expenses, and that it does so without reducing the effectiveness of Congress's statutory abuse-prevention scheme.

Before Congress adopted section 280A, a taxpayer could deduct the costs of maintaining an office in his home under either of the

28. *See* I.R.C. § 262; Treas. Reg. § 1.262-1(b)(5) (1958) (household expenses are nondeductible); Treas. Reg. § 1.262-1(b)(5) (1958) (traveling expenses nondeductible unless specifically authorized).

29. James v. United States, 308 F.2d 204, 206-08 (9th Cir. 1962).

30. *See* text at note 2 *supra*.

31. *See* Stanley v. Commissioner, 338 F.2d 434, 439 (9th Cir. 1964); Commissioner v. Kelley, 293 F.2d 904, 912 (5th Cir. 1961).

32. SENATE REPORT, *supra* note 2, at 3, [1976] U.S. CODE CONG. & AD. NEWS at 3440.

33. *See* note 42 *infra* and accompanying text.

general business expense deduction provisions: section 162, which allows "as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,"[34] or section 212, which permits taxpayers to deduct the "ordinary and necessary expenses paid or incurred during the taxable year . . . for the production or collection of income."[35] However, the IRS and the courts did not always use the same standard to determine whether home office expenses were "ordinary and necessary."[36] The Service challenged the deduction of expenses associated with employees' home offices that were not required by the employer as a "a condition of employment."[37] Some courts used a more liberal and subjective standard, requiring only that the office be "appropriate and helpful" to the taxpayer's business.[38] Under this standard, courts allowed deductions to a teacher who used a portion of his home to prepare for class,[39] and to a television advertising executive who used his den exclusively to review his day's work and to view television ads and programs.[40] Congress decided to eliminate the home office deduction in such situations because it felt that the office was primarily a personal convenience rather than a necessary element of the taxpayer's trade or business.[41] The Senate Com-

34. I.R.C. § 162(a). *See, e.g.*, Bodzin v. Commissioner, 509 F.2d 679 (4th Cir.), *cert. denied*, 423 U.S. 825 (1975).

35. I.R.C. § 212. In adopting § 280A, Congress eliminated the home office deduction for § 212 activities. *See* SENATE REPORT, *supra* note 2, at 149, [1976] U.S. CODE CONG. & AD. NEWS at 3581.

36. *See* SENATE REPORT, *supra* note 2, at 144-45, 147, [1976] U.S. CODE CONG. & AD. NEWS at 3577, 3579, and cases cited therein.

37. *See* SENATE REPORT, *supra* note 2, at 144, [1976] U.S. CODE CONG. & AD. NEWS at 3577. The IRS has consistently argued that an employee-taxpayer is entitled to a deduction for home office expenses only when that office is a condition of employment. *See* Bodzin v. Commissioner, 60 T.C. 820, 824-25 (1973), *revd.*, 509 F.2d 679 (4th Cir.), *cert. denied*, 423 U.S. 825 (1975); Gino v. Commissioner, 60 T.C. 304, 314 (1973), *revd.*, 538 F.2d 833 (9th Cir.), *cert. denied*, 429 U.S. 979 (1976); O'Connell v. Commissioner, 31 T.C.M. (CCH) 837, 842 (1972); Dietrich v. Commissioner, 30 T.C.M. (CCH) 685, 686 (1971); Rev. Rul. 62-180, 1962-2 C.B. 52, 52-53.

38. *E.g.*, Hall v. United States, 387 F. Supp 612, 616 (D.N.H. 1975); Gillis v. Commissioner, 32 T.C.M. (CCH) 429, 432 (1973); Johnson v. Commissioner, 31 T.C.M. (CCH) 941, 943 (1972); Rafferty v. Commissioner, 30 T.C.M. (CCH) 848, 850 (1971); Bischoff v. Commissioner, 25 T.C.M. (CCH) 538, 539 (1966). Other courts permitted these expenses to be deducted only when the home office was an implied condition of employment. This type of situation arose when the taxpayer's office was either inadequate, *see* Peiss v. Commissioner, 40 T.C. 78, 83-84 (1963); Dietrich v. Commissioner, 30 T.C.M. (CCH) 685, 687 (1971), or not available after working hours, *see* Kirby v. Commissioner, 40 T.C.M. (CCH) 431, 432-33 (1980).

39. *E.g.*, Hall v. United States, 387 F. Supp. 612 (D.N.H. 1975); Dietrich v. Commissioner, 30 T.C.M. (CCH) 685 (1971); Peiss v. Commissioner, 40 T.C. 78 (1963).

40. Newi v. Commissioner, 28 T.C.M. (CCH) 686 (1969), *affd.*, 432 F.2d 998 (2d Cir. 1970).

41. *See* SENATE REPORT *supra* note 2, at 3, 9-10, 147-48, [1976] U.S. CODE CONG. & AD. NEWS at 3440, 3446, 3579-80.

Some courts had previously disallowed deductions for home office expenses that seemed to be primarily personal in nature. *E.g.*, Sharon v. Commissioner, 66 T.C. 515, 523 (1976), *affd.*

mittee Report indicates that Congress wished to prevent situations in which "expenses otherwise considered nondeductible personal, living, and family expenses might be converted into deductible business expenses simply because, under the facts of the particular case, it was appropriate and helpful to perform some portion of the taxpayer's business in his personal residence."[42]

Congress sought to ensure the discreteness of personal and business expenses by replacing the subjective test used by courts interpreting section 162(a)[43] with more objective and limiting standards.[44] To objectify the analysis further, the IRS has proposed regulations that establish the criteria by which it wishes to determine a taxpayer's overall principal place of business. The Service intends to consider:

(i) the portion of the total income from business activities which is attributable to activities at each location;
(ii) the amount of time spent in business activities in each location; and
(iii) the facilities available to the taxpayer at each location.[45]

These objective factors would provide courts with greater guidance in determining the deductibility of home office expenses than does the amorphous "appropriate and helpful" standard that some courts have employed.[46] But courts can apply these criteria to each of the taxpayer's specific businesses as easily as to his overall business activity. The court could examine the taxpayer's businesses separately and determine the principal location of each. Thus, the factors proposed by the IRS provide the same degree of objectivity whether the court applies the Service's single principal place of business standard

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per curiam, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979); Meehan v. Commissioner, 66 T.C. 794, 808 (1976); Shepherd v. Commissioner, 35 T.C.M. (CCH) 219, 224 (1976); O'Connell v. Commissioner, 31 T.C.M. (CCH) 837, 843 (1972).

42. SENATE REPORT, *supra* note 2, at 147, [1976] U.S. CODE CONG. & AD. NEWS at 3580. The Committee Report indicates that Congress was particularly concerned about employees who had an office supplied by their employer, but did some work at home because it was more convenient. *See id.* The Report cites Newi v. Commissioner, 28 T.C.M. (CCH) 686 (1969), *aff'd.*, 432 F.2d 998 (2d Cir. 1970), as an example of the sort of deduction that § 280A was intended to disallow. SENATE REPORT, *supra* note 2, at 145, [1976] U.S. CODE CONG. & AD. NEWS at 3577. In that case, the taxpayer, a television network employee, worked during the day in an office supplied by the network, and used a home office during the evenings to review his day's work, view ads, and perform other tasks related to his job at the network. His office at the network was always available to him, and he was not required to do any work at home. *See* 28 T.C.M. (CCH) at 688. Congress concluded that, in such cases, the taxpayer worked at home only for his personal convenience and should not be entitled to a deduction.

43. Prior to the adoption of § 280A, several courts determined the deductibility of home office expenses by using an "appropriate and helpful" standard. *See* notes 38-42 *supra* and accompanying text.

44. *See* SENATE REPORT, *supra* note 2, at 147, [1976] U.S. CODE CONG. & AD. NEWS at 3579. The Report indicates that the Committee believed there was "a great need for definitive rules" in the area of home office deductions. *Id.*

45. Proposed Treas. Reg. § 1.280A-2(b)(2) (Aug. 7, 1980).

46. *See* note 38 *supra*.

or the more liberal standard announced by the *Curphey* court. Since both standards are equally objective, courts cannot select an interpretation of "principal place of business" on the basis of this factor.[47]

Congress, however, sought not only an objective standard, but also one that objectively prohibited the deduction of personal expenses. A standard may provide objective guidelines, yet nevertheless be inconsistent with Congress's intent, if it routinely allows taxpayers to deduct personal expenses. Neither the IRS's interpretation of "principal place of business" nor that of the *Curphey* court is subject to this criticism.

Three requirements — principal place of business, exclusivity, and regular use — together provide a sufficient guarantee that the taxpayer has incurred expenses for a business purpose. In addition to the "principal place of business" requirement, section 280A mandates that the home office be "exclusively used on a regular basis" for business purposes.[48] This means that the taxpayer must prove that a specific part of his home is used "solely for the purpose of carrying on his trade or business."[49] Although the office need not be

47. In fact, on close examination the three factors proposed by the IRS appear better suited to determining which office of a single business is its principal place of business than to deciding which of a taxpayer's businesses is his principal business. The *Curphey* court's interpretation avoids the need to make the very difficult and frequently subjective latter determination. In this sense, the Tax Court's reading of "principal place of business" may provide greater objectivity than the IRS's.

48. I.R.C. § 280A(c)(1).

49. SENATE REPORT, *supra* note 2, at 148, [1976] U.S. CODE CONG. & AD. NEWS at 3581. The "exclusive use" requirement does not apply to all of the provisions of § 280A. If the taxpayer's home is the sole fixed location of his sales business, the inventory storage space need not be exclusively used for business purposes. I.R.C. § 280A(c)(2); SENATE REPORT, *supra* note 2, at 149, [1976] U.S. CODE CONG. & AD. NEWS at 3582. Exclusive use is also not required for a deduction if a taxpayer is providing day care services in the home. I.R.C. § 280A(c)(4). Congress added this exception in 1978 because such activity cannot realistically be limited to one portion of the home yet "ordinarily result[s] in . . . incremental expenses attributable to the residence beyond those which [would] have been incurred if the residence had been used solely for personal purposes." S. REP. NO. 66, 95th Cong., 1st Sess. 91, *reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 185, 267.

A literal reading of the word "exclusively" may also create difficulties. If "exclusively" is interpreted to mean exclusively as the principal place of the particular business, it would bar deductions that should be allowed. For example, if a taxpayer had two businesses, each with its only office in the same room in the taxpayer's home, he should clearly get a deduction for home office expenses. However, the office would not be used exclusively as the principal place of either business. Under the IRS's interpretation, the taxpayer would get a deduction because the office would be his overall principal place of business, and used exclusively as such. A similar situation would arise if the home office was the principal place of one of the taxpayer's businesses, but was also used as a secondary location for a second business that had its principal place of business located elsewhere. Under this Note's analysis, the taxpayer should get a deduction because it is the principal place of one of the taxpayer's businesses. The taxpayer should not lose the deduction merely because he does some other *business* work in the office. And if the business with its principal office in the taxpayer's home is his primary business, he would be allowed a deduction under the IRS's interpretation as well.

Under both the IRS's and the *Curphey* court's interpretations, the taxpayer should get a deduction in these situations because he has incurred legitimate business expenses. But there may nevertheless be some question as to whether the *Curphey* court's separate business inter-

in a separate room, it must be physically segregated from space used for personal purposes[50] to eliminate the administrative problem of verifying the taxpayer's allocation of expenses attributable to the various uses.[51] Congress imposed the "regular use" requirement to ensure that the taxpayer actually worked in the home office, and to prohibit deductions for a room that is used to conduct business only "incidental[ly] or occasional[ly]."[52] Under either interpretation of "principal place of business," the bulk of the taxpayer's work and income, at least for one business, must be generated through the home office.[53] Although the *Curphey* court's "specific business" interpretation permits a deduction for home offices that may generate a smaller percentage of the taxpayer's total income, the business nature of the office itself remains unchanged. The office must be the headquarters for activities that qualify as a "trade or business" even under this more liberal interpretation of "principal place of business."[54] The limitations that Congress built into section 280A are thus sufficient to ensure that taxpayers may deduct only business expenses, regardless of whether "principal place of business" is read expansively or narrowly.

This conclusion is reflected in the Tax Court's decision in *Curphey*. Dr. Curphey claimed a deduction for a home office that

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pretation would authorize these deductions. All doubt could be removed by interpreting "exclusively" to mean exclusively for a business purpose. This would ensure that the expenses incurred to maintain the home office in the situations described above would be deductible. It is also consistent with Congress's goals as described in the Committee Reports, which emphasized Congress's reluctance to allow personal expenses to be transformed into business expenses. *See* note 42 *supra* and accompanying text.

50. *See* Gomez v. Commissioner, [1981] 9 FED. TAXES (P-H) ¶ 57,543 (T.C.M. Dec. 18, 1980).

51. This allocation involved several approximations and was not always calculated consistently. For example, some courts allocated expenses based on the ratio of time used for business purposes over total time used, while the IRS compared the business use to the total time that the room was available for any use. *Compare* Gino v. Commissioner, 60 T.C. 304, 314 (1973), *with* Rev. Rul. 62-180, 1962-2 C.B. 52, 54. Courts must also calculate the amount of space in the home used for business purposes. *See* SENATE REPORT, *supra* note 2, at 146-47, [1976] U.S. CODE CONG. & AD. NEWS at 3579.

52. SENATE REPORT, *supra* note 2, at 148, [1976] U.S. CODE CONG. & AD. NEWS at 3581. One court has stated in dictum that "intermittent" use does not meet the "regular basis" test. Borom v. Commissioner, 49 T.C.M. (P-H) ¶ 80,459, at 1997-98 (1980) (dictum).

53. The criteria evolved by the IRS for determining a taxpayer's principal place of business require a determination of "the amount of time spent in business activities" and "the portion of the total income from business activities" generated at each of the taxpayer's business locations. Proposed Treas. Reg. § 1.280A-2(b)(2) (Aug. 7, 1980). This test can be used to determine the principal place of either a specific business or the taxpayer's total business activity.

54. *See* SENATE REPORT, *supra* note 2, at 149, [1976] U.S. CODE CONG. & AD. NEWS at 3581.

For activity to qualify as a trade or business under I.R.C. § 162, it must consist of more than isolated transactions; courts require continuing, regularized activity, though it need not be the taxpayer's primary business. *See, e.g.*, Ehrman v. Commissioner, 120 F.2d 607, 610 (9th Cir.), *cert. denied*, 314 U.S. 668 (1941); Atkins v. United States, 14 F. Supp. 288, 290-91 (Ct. Cl. 1936).

was the principal place of his rental business. The rental business, however, was a secondary business for Curphey, since it produced less income and required less time than his medical career, which was located principally at a nearby hospital.[55] Nevertheless, the Tax Court allowed Curphey a deduction for his home office expenses.[56] It first established that, absent the home office question, expenses attributable to a secondary business are deductible as ordinary and necessary business expenses.[57] The court found no indication that Congress intended to distinguish between primary and secondary businesses when it enacted section 280A, and decided that the section was less restrictive of legitimate business expense deductions than the IRS's overall principal place of business test.[58] According to the court, its more liberal interpretation of section 280A would "fulfill the legislative objective of preventing deductions for the use of a home for reasons which are primarily personal" without excluding any otherwise legitimate home office deductions.[59] The court therefore held that a taxpayer can deduct the expenses incurred in maintaining a home office as the principal place of his second business.

Because Congress's desire for an objective standard that prohibits the deduction of purely personal expenses provides no clear basis for choosing between the alternative interpretations, we must turn to the second major policy goal — ensuring the deductibility of legitimate business expenses. Congress does not allow individuals to deduct personal expenses[60] because these expenditures reflect the disposition that taxpayers elect to make of the net income that they have previously earned.[61] Business expenditures, on the other hand, must be deducted to calculate the taxpayer's net income[62] — total earnings less the expenses and losses incurred in producing those

55. 73 T.C. 766, 767-68 (1980).

56. 73 T.C. at 776.

57. 73 T.C. at 775-76.

58. 73 T.C. at 776-77.

59. 73 T.C. at 776-77.

60. *See* I.R.C. § 262.

61. *See* James v. United States, 308 F.2d 204, 206 (9th Cir. 1962) (footnote omitted) ("[The Internal Revenue Code] reflects a purpose to tax income spent by individuals for their ordinary costs of living."); M. CHIRELSTEIN, *supra* note 2, at 86-87, 140. *See generally* Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 313 (1972); Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831, 833 (1979); Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63, 64 (1967); Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1083-84 (1980).

62. *See, e.g.*, Commissioner v. Tellier, 383 U.S. 687, 691 (1965); Commissioner v. Sullivan, 356 U.S. 27, 29 (1958); McDonald v. Commissioner, 323 U.S. 57, 66-67 (1944) (Black, J., dissenting); W. ANDERSON, TAXATION AND THE AMERICAN ECONOMY 196 (1951).

earnings.[63] Congress taxes net, rather than gross, income because it has concluded that net income is a better measure of an individual's ability to pay taxes.[64] Business expense deductions may also stimulate business growth and increase employment opportunities.[65] Because an individual pays no tax on his business expenses, he has more capital available to reinvest in his business or to spend on consumer goods. This additional capital may produce greater business income, which in turn generates additional tax revenues.[66]

It is on this ground that courts can distinguish between the IRS's "overall business" and the Tax Court's "specific business" interpretations of "principal place of business." Since the deductions allowed under either construction are legitimate business expenses, and not personal expenses,[67] Congress's intent is best satisfied by the standard that allows the greater number of legitimate business expenses to be deducted. By interpreting section 280A liberally, courts will further Congress's desire to tax only net income, to stimulate economic growth, and to increase employment opportunities.[68] The IRS, which allows taxpayers to deduct the office expenses associated with a second business not located in the home,[69] refuses to allow a taxpayer to deduct the expenses of maintaining a room in his home as the principal office of his second business.[70] This policy makes an entire class of business expenses nondeductible, and frustrates congressional intent. The *Curphey* court's analysis, on the other hand, allows this group of business expenses to be deducted. Because the *Curphey* court's approach permits a greater number of legitimate business expenses to be deducted without contravening section 280A's other goals, courts and the IRS should adopt its conclusion that section 280A authorizes deductions for expenses incurred to

63. *See, e.g.*, Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33 (1958); Higgins v. Smith, 308 U.S. 473, 477 (1940).

64. *See* M. CHIRELSTEIN, *supra* note 2, at 86; W. GREEN, THE THEORY AND PRACTICE OF MODERN TAXATION 71-72 (2d ed. 1938). *Cf.* W. ANDERSON, *supra* note 62, at 316 (discussing state gross income taxes on businesses).

65. *See* W. ANDERSON, *supra* note 62, at 311, 510-11; THE COMMITTEE ON POSTWAR TAX POLICY, A TAX PROGRAM FOR A SOLVENT AMERICA 16, 58, 82 (1945); W. RABY, THE INCOME TAX AND BUSINESS DECISIONS 42 (1964); THE RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT, TAXES AND THE BUDGET 11, 13 (1947); THE RESEARCH COMMITTEE OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT, A POSTWAR FEDERAL TAX PLAN FOR HIGH EMPLOYMENT 7 (1944); Carpenter, *Growth and Federal Income Taxes*, 37 ST. JOHN'S L. REV. 94, 99, 112-13 (1962).

66. *See* S. REP. NO. 1881, 87th Cong., 2d Sess. 1, 25, [1962] U.S. CODE CONG. & AD. NEWS 3304, 3304, 3327.

67. *See* notes 47-54 *supra* and accompanying text.

68. *See* notes 62-66 *supra* and accompanying text.

69. *See, e.g.*, Fackler v. Commissioner, 133 F.2d 509, 511-12 (6th Cir. 1943), Curphey v. Commissioner, 73 T.C. 766, 776 (1980); Treas. Reg. § 1.162-6 (1960).

70. *See* note 6 *supra*.

maintain home offices that are the principal place of any of the taxpayer's businesses.

Conclusion

Section 280A limits the availability of home office deductions. Congress now permits taxpayers to deduct these expenses in only a few specified cases, such as when the home office is the taxpayer's "principal place of business." In the case of a taxpayer with more than one business, the IRS has interpreted this provision to allow a deduction only when the home office is the principal place of the taxpayer's overall business activity. But the Tax Court recently held that the deduction was available for the principal place of any of the taxpayer's businesses.

This Note advocates the Tax Court's approach, and has demonstrated that this interpretation better satisfies the congressional policies that underlie section 280A — allowing taxpayers to deduct legitimate business expenses and prohibiting the deduction of personal expenses. The IRS and the courts should adopt this interpretation because it allows taxpayers to deduct more of the costs associated with maintaining business offices, while providing adequate guarantees that the personal expenses of maintaining a home will not be deducted under the guise of business expenses.

Pueblo, Colo., *October 26, 1981.*

John J. Salmon,
Chief Counsel, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

For the Record: By limiting deductions under section 280A, Congress has effected a cure that is more insidious than the disease. When Congress legislated "personal use" to include related parties under section 267(c)(4), it excluded the scenario where a relative of either of the two taxpayers (on joint returns) may be renting from an in-law or blood relative at a fair rental value without any intent to abuse the tax laws.

There are other well established judicial doctrines that will serve as authoritative weapons against excess loss based on a rental at less than fair market value (i.e. sham transactions, etc.).

However, if indeed the rental to a relative is based on a going rate, why should it make a difference whether the loss was to be a related or an unrelated party. The law should be amended to allow losses only if a fair rental value is charged.

Amending section 280A to indicate that a taxpayer can have more than one business and that "principal place of business" means the principal place of business activity for each and every business in which the taxpayer is engaged, not (as is IRS contention), that the taxpayer has only one principal place of business which is chosen based on a facts and circumstances test, is a necessary legislative remedy to achieve an equitable and realistic result for taxpayers. Never has it been assumed (until now) that a taxpayer cannot have more than one principal place of business even when they have more than one business. It would never be argued (for example) that a college professor who has an on-campus office cannot also run a professional practice from a rented space in a commercial building and that the rented space would not be a qualified deduction from his business. This is exactly

the kind of argument the IRS is trying to advance and their only justification for it is that the office is in the taxpayer's home. This result is unconscionable!

While I don't believe that the taxpayer should have a "free ride," we must not go so overboard with tax legislation that we create a socialistic state where everything belongs to the government. Section 280A has the capacity and has been interpreted so broadly that it goes a long way toward arbitrarily creating tax revenue. I for one do not want to see this happen. Therefore, by adopting these amendments to section 280A we will go a long way toward returning section 280A to its intended purpose, curing an abuse by taxpayers, not being a blight for the taxpayer. Unless these amendments are made retroactive, a prior inequity will go uncorrected. Let's go all the way and make these amendments effective as of the initial date of enactment of section 280A.

Sincerely,

EDITH A. CARLSON, *CPA.*

LOS ANGELES, CALIF., *October 22, 1981.*

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. SALMON: I understand that the Subcommittee on Select Revenue Measures is holding hearings in regard to legislation which would repeal or amend section 280A's so-called "family rental tax", which supposedly result from the denial of deductions for the expenses of renting a resident to a relative.

While some amendments to section 280A may be desirable, particularly in better defining personal use, I strongly oppose any substantial change to these rules.

As you know, section 280A serves several important, positive purposes. It greatly facilitates ease and efficiency in auditing. It eliminates the vague and imprecise necessity to determine whether housing rented to very close relatives is rented at fair market rental. It enables taxpayers and their advisers to predict with relative certainty the Internal Revenue Service's application of the law.

As you know, section 280A does not deny all deductions for the expenses of renting a residence to a relative. It only disallows deductions in excess of income from renting a residence to a close relative, one with whom a genuinely fair rental is almost never charged. Further, it does not limit in any way deductions for interest, taxes and casualty losses.

I have been a tax auditor for the government and a tax accountant with a large, national accounting firm. I am presently practicing law. I believe that any substantial change in the portions of section 280A which related to so-called family rental would be unwise.

Very truly yours,

NORMAN H. GREEN.

WOODBRIDGE, VA., *November 1, 1981.*

HOUSE WAYS AND MEANS COMMITTEE,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

DEAR SIRS: I just read an article by Kenneth Harney in the Washington Post (October 31, 1981) on "family-rental tax." Your address was given in the paper, and I am writing to tell of our experiences because of this horrible law.

The story of our case is enclosed. It's long, but we're a perfect example of how this law damages ordinary people. My husband is in the Army, the house in question cost $22,000, and his mother, the renter, is the mother of six sons (four of them on active duty, one killed in action in Viet Nam, one a six-year veteran). We have no fancy investments, own only that one house, and are in debt after a recent move from Hawaii to Virginia.

The IRS treated us badly in this matter. The ensuing suffering, time-loss, and anxiety are almost unimaginable—all because we are trying to help someone we love. The $472 (tax plus interest) in question may not seem like much, but we don't have much when it comes to money; besides the unfairness of the law hurts even more than the money. Ironically, the IRS must be spending several times that amount to prosecute us.

I am sending copies of this story to the Senators from California and my Congressman, Eugene Chappie, but my hope really rests with your committee and your proposed legislation to end this unfair practice.

Sincerely yours,

GLORIA H. GRITZ.

GRITZ VERSUS IRS

This is the story of a mother, her son, a $22,000 house, and the IRS. It's about a little-known piece of legislation that discriminates against an age-old tradition: a son helping his elderly mother. No one likes the law; except for one man, every IRS agent we talked to, including the lawyer who is prosecuting us, thinks the law is a bad one. For the past 17 months, we have waited for one person who would not only say, "This law wasn't meant for people like you," but one willing to back up his words with action. It now appears that can't happen in the appellate process. The judge can only rule on the law, not the case; in essence, the written word matters more than the people it affects. This law was enacted by you and your colleagues, and only you can change it. We will be going to court soon, and I ask you to amend the tax law that enables the enforcers of Section 280A to discriminate against those who still want to take care of their own instead of letting the government do it for them.

I wish you could meet my mother-in-law, Coral MacKenzie. At 64 years old, her hair is snow white; she is barely five feet tall and tends to plumpness, but still possesses incredible energy. Four years ago, she learned to ski, and while skin cancer and heart problems have become more than minor annoyances, she still hopes to receive her college degree this year. This unusual college student cries over the National Anthem and thrives on the knowledge that she has raised six sons to love America and seek lives of service. They were Eagle Scouts, class officers, and ROTC scholarship winners. While they often lived in houses without heat, where the plumbing didn't work and the water didn't run, they never applied for food stamps or welfare. They simply worked harder.

Coral's second son, John, is my husband. He washed dishes in the garbage room of Humboldt State College to finance three years of college. In 1966, he quit to enlist in the army. I thought he was a bit crazy, but he wanted to do his part. He got to OCS, went on to jump school, Special Forces, and Vietnamese language school. We were married in 1967, and later he decided to make the army his career.

We are the faceless victims of bureaucracy, penalized by our government because we wanted Coral to live in a nice house. In the fall of 1977, we were living with our four children in army quarters at the Sierra Army Depot in Herlong, California. Two years earlier, we had sold our one and only home in San Diego, planning to buy another one in Herlong, but then John's job required his presence on post. In the meantime, inflation hit the housing market. We were afraid we'd never be able to buy another house. Then we heard of a small, two-bedroom house for $22,000. We decided to buy it as a rental property and hedge against inflation.

We cashed in all of our savings bonds, accrued over the years at $18.75 a month, and then borrowed another $2,000 from my parents. Escrow closed in December. When Coral came for Christmas, she fell in love with the house and we offered it to her. Her sixth son was in his last year of college, and she thought he needed to be on his own; she moved in on February 1.

Our payment was $149.723 a month, and we decided to charge $150 for rent. At that time, a 2-bedroom apartment in Herlong rented for $85 a month, but the house had a nice yard and was worth more. When John was transferred to Hawaii, Coral decided to stay in Herlong. She was the ideal tenant for an absentee landlord. When repairs were needed, she took care of them, sending us the receipts and deducting the payments from her rent. We kept records and tried to be businesslike, but there was no need for a rental contract as the arrangement worked well for all of us.

Two years later, in June of 1980, we were informed that our 1978 return was being audited by the IRS. We had not even itemized deductions, but we were being audited for child care expenses (I had worked part-time), moving expenses, and our rental property.

We did our own taxes. By this time, John and I both had our Master's Degrees, and the one time we'd hired an accountant, he made two mistakes. I was teaching and John was CO of an infantry battalion; he was gone much of the time, so I went alone to the audit.

I had two sessions with Al Auna, our auditor. Childcare expenses were fine. The IRS owed us for moving expenses because we had forgotten to claim the final cash payment to the quarantine station for our dog and cat's stay when we moved to Hawaii. The rental property was another story.

I explained to Mr. Auna that we didn't have a rental contract because we rented to John's mother. I volunteered this information (Coral's last name is MacKenzie, not Gritz). I thought renting to her was admirable, not illegal. We had deducted some electrical work that should have been capitalized, but that was the only error on the return. After an hour or so, Mr. Auna left the room. When he returned, he informed me that under Section 280A, enacted in 1976, we could not claim a loss on a rental property if we rented to a linear descendant or ancestor.

I explained that she wasn't my husband's dependent, that while she was retired on federal disability, she was still making it on her own and wanting it that way. We discussed fair market value ($150 rent in Hawaii is unheard of), and Mr. Auna suggested I appeal his ruling. I said okay. He brought his supervisor, Ms. Denise Haverty, into the room and we explained the case to her. She decided, without any argument from Mr. Auna, that the intent of the law didn't apply to us.

Mr. Auna said he would mail us the final paperwork, but since they owed us for the moving expense and we owed them for the capitalization, it would probably work out even. In that moment, I actually liked the IRS; it had become personified by a couple of nice people who treated me like an equal person.

Weeks passed, and late in August I was awakened one morning by Jerry Hiromoto, local IRS agent. He had taken over our case, and couldn't decipher the notes Mr. Auna had left behind. Hiromoto called often. Maybe he was having a bad week, maybe he was unhappy at finishing up someone else's work, maybe he just wasn't a very nice person, but the calls resembled torture sessions. Finally, I told him to bug off; his supervisor had already ruled in our favor, and I want him to leave me alone.

He called one more time. "I talked to Ms. Haverty," he said, "and she not only remembers you, she's still ruling in your favor. I just want you to know I'm not letting either one of you get away with it."

I felt like a criminal. What was so wrong about renting a $22,000 house to our mother? Why did I have to feel crummy about trying to do something basically good? Did our government need that $426 so badly? That same week, a newspaper story told of an IRS decision not to "go after" airline pilots with $10,000 in questionable deductions and "only" $100,000 or so in annual income. They were going to concentrate instead on criminal cases. With less than $50 in interest income, no home of our own, not enough income to bother itemizing deductions, I still can't see how we fit into their plan.

Ms. Haverty called again, too. She was sorry, but she was forced to reverse her decision. She suggested we find another tenant if we wanted to be treated like normal taxpayers with rental property. If that presented a hardship for Mom, she further suggested welfare. "It's no disgrace," she told one of five healthy sons who owed a great deal to his mother.

We're military people, and we understand the chain of command. I wrote to the head of the local IRS office because I didn't think we'd been treated fairly. He said the law is the law. We filed an appeal.

In November, John and I went to our hearing together. Instead of seeing the appeal's officer, we saw the office supervisor. She explained that she was not filling Ms. Hoverty's job; she, Ms. Haverty, and Mr. Hiromoto were all under consideration for the position, and each was serving a trial time before the final selection was made. Pawns in an inter-office power struggle? Is that why we were there? She arranged for us to see Mr. Mason, the appeal's officer, that afternoon.

Mr. Mason was very plesant. He agreed with us. They didn't like to prosecute under 280A, and he offered to compromise. We felt as we do now: we are right and the law is wrong. There's no compromising on this one.

Months went by. We called Mr. Mason several times, but nothing definitive ever came from the calls. After we received orders transferring us to Virginia, we called him again and told him we needed some action on our case. We received the paperwork for tax court, and asked to have our case heard in Washington.

Now we have heard from the lawyer prosecuting our case. When I called him about the stipulations, he told me that in his ten years with the IRS, mainly in corporate law, he, too, had never heard of Section 280A until he got our case. He said what they've all said (except Hiromoto): it's a bad law, unfair, he's sorry for us, but the judge won't be affected by the circumstances, only the letter of the law.

We've followed the chain of command. We've gone up the ladder. I know you have a lot of heavy business up there on the hill, but that law needs to be changed. We are not fat cats or rich businessmen. We have spent most of our married life in government housing. We have about $1,000 in the credit union, and a little more in savings bonds. We are in debt from our last move. We work hard, serve our country, pay our taxes, and help our neighbors.

We're not complaining about the quality of our lives; what we want help on is getting an unfair law changed. If we rented to anyone else, our tax return would

have been fine. Why would anyone want to pass a law that discriminates against family life? I think you should be encouraging people to ease the financial burdens of their loved ones, not punishing them.

If there is anything you can do to help us, we would really appreciate it. If nothing specific can be done for us, at least try to change that awful law. It needs to be done away with now!

HODGSON, RUSS, ANDREWS, WOODS & GOODYEAR,
Washington, D.C., October 21, 1981.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is a written submission in connection with your Subcommittee's hearing on October 19, 1981 on proposals relating to Internal Revenue Code Section 280A. Section 280A was intended to curb abuses involving deduction of home office and rental of vacation homes. As pointed out earlier this year by former Commissioner Mortimer Caplin in testimony at a similar hearing before the Senate Subcommittee corresponding to yours, through apparent inadvertence the statutory language may preclude deduction for travel expenses of a taxpayer who maintains an apartment or residence for business purposes away from home.

Mr. Caplin cites Committee report language of both Houses that recognizes such expenses were intended to continue, if they met the tests of Section 162. Nevertheless, for example, if an apartment maintained out of town for business purposes of a taxpayer is used for personal purposes for 14 days by members of his family (even at the same time the taxpayer is using it for business), the total business usage on travel status appears by the language of Section 280A to become nondeductible.

I am enclosing for the record a copy Mr. Caplin's letter and request that it be inserted with this letter in the record of the hearing. Mr. Caplin and I join in urging you to enact the technical amendment to Section 280A that he suggests in his letter. It would leave the rules as to deductibility of expenses in travel status to the usual rules of Section 162. We are unaware of suggestions of abuse in that area. Section 280A would remain applicable in the situations of abuse to which it was directed. As Mr. Caplin points out where a dwelling unit is used for lodging at times other than for business travel, it would remain subject to Section 280A.

Sincerely,

DONALD C. LUBICK.

Enclosure.

CAPLIN & DRYSDALE,
Washington, D.C., October 27, 1981.

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, D.C.
(Attention: Mr. Richard Belas).

DEAR MR. BELAS: I am writing to call your attention to a problem involving the application of section 280A of the Internal Revenue Code of certain business traveling expenses. I believe it could be solved by simple legislation in the form of an amendment to S. 31, on which the Senate Subcommittee on Taxation and Debt Management held a hearing on February 23, 1981.

THE PROBLEM

The problem concerns the allowability of various deductions with respect to the use of a dwelling unit as lodging by a taxpayer who is traveling away from home on business. A taxpayer who frequently travels to a particular city on business often prefers to lease an apartment or rent one on a month-to-month basis, or to buy a condominium or cooperative apartment, rather than to stay in a hotel. In some cases, the cost of maintaining an apartment is less that it would cost to rent a hotel room on each business trip, and in most cases, the taxpayer finds it more convenient to have an apartment available on a regular basis. Sometimes an apartment is rented or purchased for use by one or more business associates. For example, a law firm might maintain an apartment for use by its members who are required to be in a particular city for business reasons. On occasion, the apartment, used predominantly for business traveling, might also be used in the course of personal traveling.

To the extent that an apartment is used as lodging by persons in a legitimate business travel status, the expenses of maintaining it (like hotel costs) would clearly be deductible in the absence of section 280A—unless the expenses were "lavish or extravagant under the circumstances" with the meaning of section 162(a)(2). In fact,

the allowability of such deductions is recognized in the explanation of section 280A contained in both the House and Senate committee reports on the Tax Reform Act of 1976: [1]

With respect to an apartment or residence used by a taxpayer while in a travel status, the expenses attributable to the maintenance of the apartment or residence are treated as lodging expenses subject to certain other rules relating to deductibility (sec. 162). As such, the expenses are deductible only if they are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it. "Lavish or extravagant" expenses are not allowable deductions. The expenses attributable to the apartment or house are deductible as lodging expenses if properly allocable to the taxpayer's trade or business even though the transportation expenses are not deductible because the trip was undertaken primarily for personal purposes.

Despite this clear explanation, other language in the committee reports could be read as indicating Congress intent to displace all prior law by imposing a new set of restrictions on the deductibility of any expenses with respect to a dwelling unit—including those what would otherwise qualify as traveling expenses. Also, the language of section 280A itself, which broadly defines the term "dwelling unit" and applies to any dwelling unit used during a taxable year for personal purposes for more than the greater of 14 days or 10 percent of the number of days the unit is rented, leaves room for an interpretation that requires disallowance of the deduction of traveling expenses.

If section 280A were applicable to traveling expenses: (a) expenses that might not be deductible include rent, or in the case of a condominium or cooperative apartment owned by the taxpayer, depreciation, fees or assessments paid to an owners' association, and other maintenance costs; and (b) even if an exception were available under section 280A(c), these traveling expenses would still be subject to the limitations contained in section 280A(c)(5).

Moreover, it seems unlikely that Congress intended to require the total disallowance of traveling expense deductions merely because an apartment is sometimes used for personal purposes. The rules for deducting traveling expenses, as described in the committee reports, were clear and not criticized at the time section 280A was enacted; and the focus of section 280A was on vacation homes and home offices, both of which were subject to substantial abuse. This abuse potential is not true for the traveling expense deductions, which are controlled by well-established rules under section 162(a)(2).

SUGGESTED SOLUTION

The ambiguity with respect to the applicability of section 280A to traveling expense deductions could be removed by the following simple amendment to section 280A comprised of a new subsection (d) of Section 1 of S. 31;

(d) Exception for traveling expenses.—Subsection (b) of section 280A of such Code is amended—

(1) by inserting "TRAVELING EXPENSES," before "ETC." in the caption, and

(2) by striking out "." and inserting in lieu thereof ", or any deduction allowable under section 162(a)(2)."

To remove the ambiguity retroactively, it would be necessary to insert ", (b), and (d)" in place of "and (b)" in Section 2 of S. 31.

This amendment is very narrow, since it allows only deductions for traveling expenses which meet all the requirements of section 162(a)(2). For cases where a dwelling unit is used at times as lodging in the course of business traveling and at other times for other business activities—for example, as a home office or for rental as a vacation home—the deductibility of expenses relating to these other uses would continue to be governed by the limitations of section 280A

I hope that the Subcommittee will rectify the traveling expense problem by an amendment similar to the one suggested above.

Sincerely,

MORTIMER M. CAPLIN.

STATEMENT OF THE NATIONAL EDUCATION ASSOCIATION

Mr. Chairman, the 1.7 million member National Education Association is happy to have an opportunity to present this testimony to the Subcommittee on Select Revenue Measures. We would like to make a few observations and suggestions to

[1] H.R. Rep. No. 658, 94th Cong., 1st Sess. 158 (1975); S. Rep. No. 938, 94th Cong., 2d Sess. 145 (1976).

the Subcommittee which we feel will make the Internal Revenue Code, Section 280A, applicable to teachers as well as to other taxpayers.

Attached to this statement is a copy of the NEA response to the regulations IRS proposed last year. I request that this be made a part of the record.

Teachers, like many other citizens, are often forced to moonlight to make ends meet. Teachers—who are taxpayers, too—deserve to deduct that portion of their residence which is used for the exclusive and regular purpose of storage of inventory, meeting clients, or managing their independent business.

As important as that needed correction in the tax law is, we urge you to go further. Teachers in every school district in America are concerned that IRS forbids a deduction of a home office even though they use office space at the direction or for the convenience of their employer. The 8,000 delegates to the 1981 NEA Representative Assembly adopted the following policy statement of the issue:

E-8. TAX DEDUCTIONS FOR PROFESSIONAL EXPENSES

The National Education Association believes that educators must continuously develop professionally and that expenses incurred to do so are professional expenses and must be uniformly deductible, as an adjustment, from gross income in the computation of federal and state income taxes. Included in such deductible expenses are those incurred on sabbatical leave or for educational travel for the maintenance and improvement of teaching skills, and those incurred by maintaining an office in the educator's home. (69, 78)

Many school systems encourage or require teachers to leave school buildings shortly after school is dismissed because the district wishes to conserve fuel and/or school buildings are considered unsafe after hours. This means that many teachers are forced to meet students and parents as well as prepare and evaluate educational activities in their homes. However, even though teachers' home offices are required by school districts or are convenient for the employer, tax laws and IRS rules do not allow teachers a tax deduction for the use of their homes for their business—fulfilling their educational responsibilities.

The Education for All Handicapped Children Act of 1975 (Public Law 94-142) requires that Individual Educational Programs (IEP's) be prepared for all handicapped students whose parents so request. These IEP's require teachers and school counselors to work with local health officials, parents, and other persons who will supplement the educational program of the handicapped youngster. Since school buildings are often not available during the hours needed for consultation, teachers must meet their clients and other professionals in their homes. Most teachers understand that the activity is their professional responsibility, which they accept, but they don't understand why laws and/or rules prohibit them from claiming a tax deduction for the office space used for their required activities on a regular, exclusive, and continuing basis.

Teachers are also required to sponsor extracurricular activities. Many times, either school facilities are unavailable or it is not convenient for the school system for these activities to be planned and carried out on school property, so someplace other than the school, such as the teacher's home, must be used, especially if the activity is a club meeting of a relatively small group of students. Again, teachers accept this as a part of their teaching duties but IRS and tax laws preclude any deduction of regularly used home facilities.

It might be useful for the record to illustrate what is required of teachers and why they must use their homes as a principal place of business.

In a mid-western city there is a teacher of English to inner city high school juniors. He is a teacher dedicated to helping his students learn to read and write. He teaches five classes each day, each with its own separate preparation since the students are "ability grouped." Each pupil is required to write a two-page theme each week plus four or five book reports each semester. This means that in addition to 25 preparations he has over 320 pages of composition to evaluate each week.

Each teacher is accorded a 50 minute planning period. Most teachers, including this English teacher, use it productively. However, he spends three to four hours five nights a week working at home because the school building closes at 4:30 p.m. School officials are concerned about fuel costs so the heat is turned off at 4 p.m. Teachers are specifically "requested" to leave the building by 4:30 p.m. because the school district doesn't want to be responsible for teacher safety after that time.

The teacher in this example—and teachers across the country—cannot claim a deduction for the room used exclusively and regularly to conduct school business even though activities at home are for the convenience of the employer.

In order to achieve the goal of according teachers the deduction for regularly used home facilities, NEA strongly recommends that the Internal Revenue Code be amended to add "students and/or their parents" to the list of persons who qualify a

taxpayer under section 280A(c)(1)(B) of the Internal Revenue Code. That section states that a deduction is available to taxpayers who use a portion of their homes exclusively and regularly to meet "patients, clients, or customers." As the law currently stands, teachers probably will have not satisfied the IRS that students and/or their parents fall within the definition of patient, client, or customer as set forth in section 280A(c)(1)(B), even though one may construe students or their parents to be clients of the teacher. The language we propose will allow teachers to be treated equally with doctors, lawyers, health care practitioners, and other business and professional persons.

The issue is one of equity, not preference. Teachers are taxpayers who expect fair treatment by the federal tax code. They expect to be able to deduct an office if it is used exclusively and regularly at the direction of or for the convenience of their employers, To exclude teachers from this deduction discriminates against one class of American taxpayers.

NATIONAL EDUCATION ASSOCIATION,
Washington, D.C., October 6, 1980.

Re Proposed Treas. Reg. section 1.280A-2 (August 7, 1980).

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.

DEAR SIR: The National Education Association ("NEA"), is an employee organization of approximately 1.8 million teachers employed in schools, colleges and universities throughout the United States. NEA respectfully submits the following comments regarding the proposed regulations and requests an opportunity to present comments orally at a public hearing regarding these proposed regulations.

1. Deductions for business use of home—Prop. Reg. section 1.280A-2 Generally

Section 162(a) of the Internal Revenue Code allows deductions for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Section 262 of the Code provides that no deduction shall be allowed for personal, living, or family expenses, except as otherwise provided. The expenses of maintaining a household are defined by Reg. section 1.262-1 as personal, and therefore nondeductible, expenses. Section 280A generally disallows deductions for expenses incurred with respect to the business use of a taxpayer's residence, with certain exceptions.

The three exceptions pertinent to the following comments are set forth in section 280A(c)(1), which allows a deduction for an item of expense which is allocable to a portion of the dwelling unit which is exclusively used on a regular basis: (A) as the taxpayer's principal place of business; (B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business; or (C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

The legislative purpose of section 280A was, in part, to provide definitive rules concerning deductions for expenses relating to business use of a taxpayer's residence in order to prevent deductions of expenses which are primarily personal in nature.

2. Principal place of business exception

The statute provides an exception for expenses allocable to the business use of a portion of a taxpayer's home which serves as his "principal place of business." As stated in the Preamble to the proposed regulations under section 280A of the Code, the proposed regulations do not follow the position of the Tax Court evidenced in *Edwin R. Curphey* v. *Comr.*, 73 T.C. No. 61 (February 4, 1980). Rather, Prop. Reg. section 1.280A-2(b)(2) states that a taxpayer may have only one principal place of business for purposes of section 280A.

The Internal Revenue Service's interpretation of section 280A(c)(1)(A) is excessively restrictive and is not supported by the legislative history of section 280A. The legislative purpose of enacting section 280A was to prevent taxpayers from deducting expenses which are either essentially personal in nature or only marginally related to income producing activities. The statute does not deny deductions for ordinary and necessary expenses incurred in connection with the conduct of activity which may legitimately be characterized as a trade or business. A "principal place of business" is not the same as a "principal business." There is nothing in the legislative history which compels the Internal Revenue Service to adopt this unnecessarily broad interpretation of the statutory language.

A rule which limits a taxpayer to a single trade or business for purposes of section 280A fundamentally discriminates against persons engaged in seasonal or part time work. A seasonal worker may have one trade or business during one part

of the year and a seasonal trade or business at other times. Similarly, when the earnings from one business or employment are not adequate to support a taxpayer's family, the taxpayer may seek a secondary source of income by engaging in a genuine trade or business on a part time basis.

Teachers are often in these circumstances. Because the normal school year is ten months, teachers frequently undertake substantial, independent business activities in the summer months. These activities may be the taxpayer's principal trade or business during that period of time. Also, because of the relatively low compensation paid to teachers, they often are impelled to work after school hours to make ends meet. These after-school activities may qualify as a trade business.

In these circumstances, the proposed regulations will operate in a discriminatory fashion. Consider two taxpayers, each engaged in the same trade or business and each of whom uses his or her home for business purposes to the same extent. For example, both are part time sales people who store their inventory and keep their records in a room at home used exclusively for that purpose. Under the proposed regulations, however, one taxpayer will be entitled to a deduction for the business use of the home because he or she is not employed or engaged in a trade or business elsewhere. The other taxpayer, however, will be denied the same deduction because his or her primary employment is teaching school.

There is no mandate in section 280A requiring this result. The "principal business" rule is not germane to the purposes of section 280A—which is to assure that the business use of the home is genuinely essential, not merely helpful or appropriate, to the conduct of the enterprise. The business use of a home may be essential to the enterprise and therefore the expenses of its operation should be deductible, regardless of whether the business in question is the taxpayer's primary or secondary source of income.

Accordingly, Prop. Reg. section 1.280A-2(b)(2) should be modified to recognize that taxpayers often have more than one trade or business. As long as the home office is the "principal place" from which a trade or business is conducted, deduction of office expenses should be allowed under section 280A.

3. Use of residence as a meeting place

Section 280A(c)(1)(B) provides an exception for business expenses incurred which are allocable to a portion of a dwelling unit used exclusively and regularly as a place of business in which patients, clients, or customers meet or deal with the taxpayer in the normal course of the taxpayer's business. Prop. Reg. section 1.280A-2(c) states that this exception applies only if use of the residence as a meeting place is substantial and integral to the conduct of the taxpayer's business. This exception does not require that the taxpayer's home office constitutes his principal place of business, but requires merely that it serve as a place of business.

The statutory exception lists three groups of persons with whom the taxpayer can meet in his home: patients, clients and customers. The legislative history does not indicate that the groups listed in this exception should be read narrowly. In light of the fact that each group is part of a professional relationship with the taxpayer, the section 280A proposed regulations should expressly provide that the groups listed in the exception are illustrative, not exhaustive. Students who come to the teacher's home for tutoring, for example, bear a similar, if not identical, relationship to their teacher/tutor as clients bear to their lawyers, or patients to their doctors. Consequently, teachers who open their homes for tutoring students and who otherwise meet the requirements of section 280A should be permitted to deduct expenses allocable to the portion of their homes devoted exclusively to and used regularly as a place for meeting students.

Respectfully submitted,

MAURICE JOSEPH, *Staff Counsel.*

PUEBLO, COLO., *October 28, 1981.*

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR SIRS: As an interested citizen and an accounting specialist (CPA), I would like to cast a vote for changes to equity and fairness (something the tax laws are too often accused of lacking).

I vote for an amendment of § 280A to recognize the logic that a taxpayer with two sources of income (more and more common and often necessary) may have a separate "principal place of business" for each. Examples abound of professionals and craftsmen who have such a duplicity of sources of income and I question the

wisdom of discouraging this industriousness as I perceive it to be a major contributing factor in the strength of our nation.

The amendment of § 280A to allow the taxpayer with a rental property to rent to whomever he chooses (without a tax penalty) makes good sense. If the objection is that the rental amount charged will not be fair, then put *that* in the law. A person who owns a rental property has one major concern (that is not subject to insurance) that the renter will take good care of the property. Why should he be penalized for making a selection of renter which is in his economic "best interest?"

Please give these amendments your sincere and thoughtful consideration.

Sincerely,

ROBERT J. VOSS, *CPA.*

Investment Tax Credit for Educational Filmstrips

97TH CONGRESS
1ST SESSION

H. R. 2295

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of educational filmstrips.

IN THE HOUSE OF REPRESENTATIVES

MARCH 4, 1981

Mr. DOWNEY (for himself, Mr. PORTER, Mr. OTTINGER, and Mr. PICKLE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of educational filmstrips.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subparagraph (B) of paragraph (1) of section 48(k) of the Internal Revenue Code of 1954 (relating to the investment tax credit for movie and television films) is amended to read as follows:

"(B) QUALIFIED FILM DEFINED.—For purposes of this subsection, the term 'qualified film' means any motion picture film or video tape cre-

ated primarily for use as public entertainment or for educational purposes. Such term includes educational filmstrips. Such term does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature.".

SEC. 2. EFFECTIVE DATE.—The amendments made by this Act apply to taxable years beginning after December 31, 1974.

SUMMARY AND DESCRIPTION

PRESENT LAW

Under present law, taxpayers are entitled to a 10-percent tax credit for investments in tangible personal property and certain other tangible property used in a trade or business or for the production of income (i.e., section 38 property). Under the investment credit rules, the amount of the credit depends upon the period the property is held by the taxpayer. However, prior to 1976, the eligibility of movie and television films for the investment tax credit and the determination of the amount of the credit for such films was unclear.

In the Tax Reform Act of 1976, Congress provided rules to clarify the application of the investment tax credit to movie and television films. Under these rules a 6⅔ percent credit is generally available for a "qualified film" regardless of the useful life (or foreign use) of the property, unless the taxpayer elects to have the amount of the credit computed on a film-by-film basis under the 90-percent rule.[1] A "qualified film" is defined as any motion picture film or video tape created primarily for use as public entertainment or for educational purposes, the market for which is not primarily topical or essentially transitory in nature.

Generally, films used in primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries and government agencies qualify for the investment credit. Films and tapes created primarily for use by industrial and commercial organizations, such as advertisements and industrial training films and tapes do not qualify for the credit. A film or tape is topical or essentially transitory if it primarily deals with events and personalities of current interest at the time the film or tape is placed in service. Thus, the news shows such as the evening news and news specials relating to current affairs, interview shows such as "The Tonight Show" or "Meet the Press," game shows, award shows, and sporting event shows do not qualify for the credit. The 1976 Act rules apply to films placed in service in taxable years beginning after December 31, 1974.

Educational filmstrips are similar to educational motion picture films except that, in the case of the filmstrip, the film consists of individual slides or frames rather than one continuous series of action. The regulations issued by the Treasury Department provide that a film or tape includes the original negatives and all sound recordings created to simultaneously accompany the pictorial material. Treas. Reg. sec. 1.48-8(a)(3). These regulations do not indicate whether educational filmstrips qualify for the special rules for qualified films.

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[1] Under the 90-percent rule, the amount of the investment credit for each qualified film is determined under the normal investment credit rules with the end of the useful life of each film considered to occur at the end of the year in which the total allowable depreciation deduction is equal to at least 90 percent of the basis of the film.

ISSUE

The issue is whether educational filmstrips should be eligible for the investment tax credit and, if so, what should be the effective date of the amendment.

EXPLANATION OF THE BILL

The bill would clarify the definition of "qualified film" to include educational filmstrips. Educational filmstrips would be subject to the same rules governing the investment credit for other movies and films.

EFFECTIVE DATE

The provisions of the bill would apply to taxable years beginning after December 31, 1974.

REVENUE EFFECT

It is estimated that this bill would reduce budget receipts by $2 million per year for fiscal years 1982 through 1986.

ESQUIRE, INC.,
New York, N.Y., October 29, 1981.

Mr. JOHN J. SALMON,
Chief Counsel, Committee of Ways and Means,
U.S. House of Representatives, Washington, D.C.

DEAR MR. SALMON: On October 1981, I was present at the hearings held by the Subcommittee on Select Revenue Measures, Committee on Ways and Means. As an employee of Esquire, Inc., a company which manufacturers and sells various educational materials including filmstrips, I was primarily interested in H.R. 2295 which deals with the investment tax credit on filmstrips.

I support this legislation. The Treasury's written and oral testimony on this matter indicates their opposition to this legislation. The Treasury Department's written testimony set forth some background to place the issues raised by this legislation in perspective. I agree with this approach but disagree with the impression left by the Treasury's presentation. Accordingly, I would like to offer the following version of the background.

The investment tax credit was enacted in 1962 to increase job opportunities for American workers by stimulating investment in the productive facilities. The credit was, and except for recent changes involving rehabilitated buildings, still is allowed on investments in durable property used in the productive process. Certainly a master filmstrip which can be used to produce up to 1,000 copies of a filmstrip for sale to educational customers should be considered durable property used in the production process. In 1962, the appropriate Senate Finance Committee Report did not discuss the applicability of the credit to master film, filmstrips, tapes etc., but it did make the following statement concerning what property qualifies for the credit:

"Except for the exclusions noted below, all tangible personal property qualifies as section 38-property. Tangible personal property is *not* intended to be defined narrowly here, nor to necessarily follow the rules of State law." (Emphasis added.) S. Rep. No. 1881, 87th Cong., 2nd Sess., reprinted in (1962) U.S. Code Cong., & Admin. News. p. 3318. Notwithstanding this direction to define tangible personal property broadly, the Internal Revenue Service has historically taken the position that motion picture film masters, filmstrip masters, etc., are intangible personal property which does not qualify for the investment tax credit.

Fortunately, the Courts have consistently disagreed with the Internal Revenue Service. The first case which did so was *Walt Disney Productions* v. *United States*, 327 F. Supp., 1891 (C.D. Cal 1971) in which the district court determined that motion picture film masters were tangible personal property. This result is not startling in light of the fact the motion picture film masters can be picked up, looked at, felt and physically carted away like most other tangible personal property which qualifies for the credit. I would like to note that a filmstrip master is virtually the same item as a motion picture film master except that one has thousands of separate images while the other contains fifty to one hundred fifty such separate images.

When the investment tax credit was reenacted in 1971, no change was made in the definition of tangible personal property. The Senate Finance Committee did however, indicate that it agreed with the court in *Walt Disney Productions* v. *United States* (cited above) where motion picture film masters were held to be tangible personal property qualifying for the investment tax credit. Between the enactment

of the Revenue Act of 1971 and the Tax Reform Act of 1976 additional cases held that motion picture film masters were tangible personal property which qualified for the investment tax credit.

The Tax Reform Act of 1976 did not change the definition of Section 38 property but did include section 48(k) of the Internal Revenue Code which was designed to resolve useful life, qualified investment and other troublesome administrative questions relating to motion picture film masters.

Accordingly, a review of the background would seem to indicate that the courts and the Senate Finance Committee agree that motion picture film masters are tangible personal property eligible for the investment tax credit while section 48(k) resolves some of the technical issues involving what costs qualify for the credit and how the useful life should be computed.

At the hearings on the proposed regulations concerning section 48(k) the film strip issue was raised since the proposed regulations was silent on the matter. The final edition of the regulations was also silent as to whether or not film strips were included as motion picture films. Many taxpayers were under the impression that filmstrips was included as motion picture film masters because of the similarity in physical nature. This taxpayer's belief was shattered on November 6, 1979 when the Internal Revenue Service issued Manual Supplement 45G-321. This supplement was long awaited by taxpayers since it was supposed to set forth the administrative methodologies to be used by revenue agents in applying the final regulations.

Despite the fact that the regulations were silent in this areas, Manual Supplement 45G-321, states:

"In general, a qualified film is a motion picture or video tape (*not filmstrip*) used for public entertainment or educational purposes." (Emphasis added.)

Seemingly, this is a circumstance of the Internal Revenue Service attempting to legislate by "administration" in an area already pre-empted by Congress. To the best of my knowledge, the distinction made between motion picture film masters and film strip masters is being made by the Internal Revenue Service on the technical ground that film strips do not convey information in a format involving motion. Query, would the master of a motion picture film containing only one image for its entire length qualify for the credit? This administrative opinion of the Internal Revenue Service seems grossly inconsistent with the original language of the Senate Finance Committee Report indicating that "tangible personal property" is not intended to be defined narrowly. I contend that film strips are so similar to motion picture films and video tapes that they should be considered as the same item.

Because the Internal Revenue Service and the Treasury Department are not of the same persuasion this legislation is required.

At this point, I feel compelled to comment concerning the written Treasury Testimony arguing that the principles of section 48(k) be confined to the movie area. The last sentence of the second paragraph on page 17 states as follows: "Thus, we believe that the credit should be allowable for the costs of producing such items as records (i.e., the master record), books, (computer tapes or plates), lithographs, (plates), and computer software."

A quick reading of this sentence would lead the reader to believe that book plates are not eligible for the investment tax credit and accordingly, film strip masters also should not qualify. This reading would be incorrect since Rev. Rul. 70-403, 1970-2 C.B.3 holds that offset lithograph films and electroplates used in the production of copyrighted books are tangible personal property that qualifies for the investment tax credit. Secondly, in Rev. Rul 81-239 IRB 1981-42, 6 the Treasury recently refined this earlier revenue ruling and indicates more clearly what costs it believes qualify for the credit. Thus, the Treasury has clearly stated that book plates qualify for the credit. I am surprised that such testimony would be given to the Committee without mentioning Treasury's current published position.

I believe that H.R. 2295 is not really an extension or modification of section 48(k) but is the most expenditious way of forcing the Internal Revenue Service to interpet section 48(k) as was intended by Congress. I further believe that the $2,000,000 per year expected revenue loss is a small cost to assist a struggling educational industry that is continuing to suffer the blows of budget cuts.

Very truly yours,

WALTER J. BEMBENISTA.

Treatment of Certain Finance Companies as Personal Holding Companies

97TH CONGRESS
1ST SESSION

H. R. 2397

To amend the Internal Revenue Code of 1954 with respect to the treatment of certain lending or finance businesses for purposes of the tax on personal holding companies.

IN THE HOUSE OF REPRESENTATIVES

MARCH 10, 1981

Mr. HOLLAND introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the treatment of certain lending or finance businesses for purposes of the tax on personal holding companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) clause (ii) of section 542(c)(6)(C) of the Internal Revenue Code of 1954 (relating to exceptions from definition of personal holding company) is amended by striking out "but not $1,000,000".

(b) Clause (i) of section 542(d)(1)(B) of such Code is amended to read as follows:

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"(i) making loans, or purchasing or discounting accounts receivable, notes, or installment obligations, if (at the time of the loan, purchase, or discount) the remaining maturity exceeds 144 months; unless—

"(I) the loans, notes, or installment obligations are evidenced or secured by contracts of conditional sale, chattel mortgages, or chattel lease agreements arising out of the sale of goods or services in the course of the borrower's or transferor's trade or business, or

"(II) the loans, advances or installment obligations are made or acquired by the taxpayer and meet the requirements of subparagraph (C)."

(c) Paragraph (1) of section 542(d) of such Code is amended by adding at the end thereof the following new subparagraph:

"(C) INDEFINITE MATURITY CREDIT TRANSACTIONS.—For purposes of subparagraph (B)(i), a loan, advance, or installment obligation meets the requirements of this subparagraph if it is made under an agreement—

"(i) under which the creditor agrees to make loans or advances (not in excess of an agreed upon maximum amount) from time to time to or for the account of the debtor upon request, and

"(ii) under which the debtor may repay the loan, advance or installment obligation in full or in installments."

(d) The amendments made by this section shall apply to taxable years beginning on or after December 31, 1980.

SUMMARY AND DESCRIPTION

PRESENT LAW

In general

Code section 541 imposes a tax on the undistributed personal holding company income of a personal holding company. This provision is intended to prevent individuals from avoiding the graduated individual tax rates (up to 70 percent before the effective date of the Economic Recovery Tax Act of 1981 (ERTA)) by holding investments through corporations, which are subject to a maximum tax rate of 46 percent. Accordingly, prior to the effective date of ERTA, the personal holding company tax is 70 percent of undistributed personal holding company income. However, pursuant to ERTA section 101(d)(2), the applicable tax rate is 50 percent for taxable years beginning after December 31, 1981.

A corporation constitutes a personal holding company if 60 percent of its adjusted gross income is personal holding company income and if 50 percent of its stock is owned by five or fewer shareholders at any time during the last half of the taxable year. Personal holding company income generally is defined as interest, dividends, royalties, rents, and certain other types of passive investment income.

Exclusion for lending, finance companies

Certain types of corporations, actively engaged in a trade or business which produces income that usually would be considered passive investment income, are excluded from the personal holding company tax provisions. Among the corporations excluded from these provisions are lending or finance companies.

A corporation qualifies as a lending or finance company if 60 percent of its ordinary gross income is derived from the active and regular conduct of a lending or finance business and certain other requirements are satisfied. The term "lending or finance business" is defined, in part, to mean a business of making loans, or purchasing or discounting accounts receivable, notes, or installment obligations, which at the date of the loan or acquisition have a remaining maturity of no more than 60 months. An exception to the 60-month rule is provided for loans, notes, or obligations secured by a security interest in personal property where the security interest arose out of the sale of goods or services in the course of the borrower's or transferor's trade or business.

The personal holding company provisions also apply a business expense test in determining whether a corporation is engaged in the active and regular conduct of a lending or finance business. Under this requirement, a corporation does not qualify as a lending or finance company exempt from the personal holding company provisions unless the sum of its business expenses directly allocable to its lending or finance business equals or exceeds 15 percent of the first $500,000 of its ordinary

gross income derived from a lending or finance business plus five percent of such ordinary gross income from $500,000 to $1 million.

ISSUES

The issues are whether to broaden the exclusion from personal holding company status for lending or finance businesses to include the business of making revolving credit loans or loans with maximum maturities of 144 months, and whether to modify the business expense test in determining whether a corporation is engaged in the active and regular conduct of a lending or finance business.

EXPLANATION OF THE BILL

The bill would modify both the 60-month maturity limitation and the business expense requirement of the lending or finance company exception to the personal holding company provisions.

Under the bill, the definition of a lending or finance business would be broadened to include the business of making loans with maturities up to 144 months and to include the business of making certain types of revolving credit loans. Revolving credit loans qualifying under the bill would be such loans made under an agreement which provides that the creditor will make loans or advances (not in excess of an agreed upon maximum amount) from time to time for the account of the debtor upon request and which provides that the debtor may repay the loan, advance, or installment obligation in full or in installments.

The bill also would modify the amount of business expenses required in determining whether a corporation with more than $1 million in ordinary gross income from a lending or finance business is a lending or finance company. Under the bill, a corporation would satisfy the business expense test only if its qualifying business expenses equal or exceed 15 percent of the first $500,000 of ordinary gross income derived from a lending or finance business, plus five percent of such ordinary gross income in excess of $500,000.

EFFECTIVE DATE

The provisions of the bill would apply to taxable years beginning on or after December 31, 1980.

REVENUE EFFECT

It is estimated that the bill would reduce budget receipts by less than $5 million annually.

Accrual of Tax Deductions After Change in Liability Date

97TH CONGRESS
1ST SESSION

H. R. 2860

To amend the Internal Revenue Code of 1954 with respect to the limitation on the acceleration of the accrual of taxes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 25, 1981

Mr. STARK introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the limitation on the acceleration of the accrual of taxes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 461 of the Internal Revenue Code of 1954 (relating to general rule for taxable year of deduction) is amended by adding at the end thereof the following new subsection:

"(h) SUBSECTION (D) NOT APPLICABLE IN CASE OF ELECTION OR CERTAIN TAXPAYERS NOT PREVIOUSLY SUBJECT TO THE ACCELERATED TAX.—

"(1) IN GENERAL.—Subsection (d)(1) shall not apply to any action of a taxing jurisdiction—

"(A) if the taxpayer makes an election under this paragraph with respect to such action, or

"(B) if, at no time before such action took effect, had the taxpayer been liable for any tax the time for accrual of which was accelerated by such change (determined without regard to subsection (d)).

"(2) SUSPENSE ACCOUNT IN CASE OF ELECTION.—

"(A) IN GENERAL.—If the taxpayer makes an election under paragraph (1) with respect to any action of a taxing jurisdiction, in lieu of applying section 481, the taxpayer shall establish a suspense account for each tax the accrual of which was accelerated by such change.

"(B) INITIAL OPENING BALANCE.—The opening balance of the suspense account established under subparagraph (A) with respect to any tax for the first taxable year to which the election applies shall be the largest amount of such taxes which would have been allowable as a deduction to the taxpayer for any of the 3 immediately preceding taxable years if—

"(i) the election under such paragraph applied to each of such preceding taxable years, and

"(ii) the action with respect to which the election was made had been in effect at all times during such preceding taxable years.

"(C) ADJUSTMENTS IN SUSPENSE ACCOUNT.—

"(i) REDUCTION.—At the close of each taxable year, the suspense account shall be reduced by the excess (if any) of—

"(I) the opening balance of the suspense account for the taxable year, over

"(II) the amount allowable as a deduction for the taxable year for the taxes with respect to which the account was established.

"(ii) INCREASE.—At the close of each taxable year, the suspense account shall be increased (but not in excess of the initial opening balance) by the excess (if any) of—

"(I) the amount allowable as a deduction for the taxable year for the

taxes with respect to which the account was established, over

"(II) the opening balance of the suspense account for the taxable year.

"(iii) SPECIAL RULE FOR INCOME TAXES.—If the tax with respect to which the suspense account was established is an income tax, for purposes of clause (i), the amount of the deduction referred to in clause (i)(II) shall not be less than the amount of such deduction allowable for the taxable year (of the 2 immediately preceding taxable years) for which such deduction is the greater. For purposes of the preceding sentence, the election under paragraph (1) and the action with respect to which the election was made shall be deemed to have been in effect at all times during such preceding taxable years.

"(D) INCOME ADJUSTMENTS.—

"(i) REDUCTIONS ALLOWED AS A DEDUCTION.—In the case of any reduction under subparagraph (C)(i) in the account for the taxable year, an amount equal to such

reduction shall be allowed as a deduction for such taxable year.

"(ii) INCREASES ADDED TO GROSS INCOME.—In the case of any increase under subparagraph (C)(ii) in the account for the taxable year, an amount equal to such increase shall be included in gross income for such taxable year.

If the amount described in subparagraph (B) exceeds the amount of the deduction which would have been allowable for the taxes with respect to which the account was established for the taxable year preceding the first taxable year for which the election is effective, then an amount equal to the amount of such excess shall be included in gross income for such first taxable year. For purposes of the preceding sentence, the election under paragraph (1) and the action with respect to which the election was made shall be deemed to have been in effect at all times during such preceding taxable year.

"(3) ELECTION.—

"(A) IN GENERAL.—An election under paragraph (1) may be made without the consent of the Secretary. Such an election shall be made in such

manner as the Secretary may by regulations prescribe and shall be made for any taxable year not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

"(B) PERIOD TO WHICH ELECTION APPLIES.—An election under paragraph (1) shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

"(C) TREATMENT AS METHOD OF ACCOUNTING.—Except to the extent inconsistent with the provisions of this subsection, for purposes of this subtitle, the computation of taxable income under an election made under paragraph (1) shall be treated as a method of accounting.

"(4) SPECIAL RULES.—

"(A) SUBSTITUTED TAXES.—Under regulations prescribed by the Secretary, for purposes of this subsection, if any tax is enacted as a substitute for a substantially similar tax, such taxes shall be treated as the same tax.

"(B) SUBCHAPTER C TRANSACTIONS.—The application of this subsection with respect to a

taxpayer which is a party to any transaction with respect to which there is nonrecognition of gain or loss to any party by reason of subchapter C, shall be determined under regulations prescribed by the Secretary."

(b)(1) Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply to taxable years ending on or after the date of the enactment of this Act.

(2) Subparagraph (B) of section 461(h)(1) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall only apply with respect to actions of taxing jurisdictions taken after the date of the enactment of this Act.

(3)(A) If—

(i) a taxpayer makes an election under section 461(h)(1)(A) of the Internal Revenue Code of 1954 (as added by subsection (a)) with respect to any action of a taxing jurisdiction for the taxpayer's first or second taxable year ending on or after the date of the enactment of this Act,

(ii) the action taken by the taxing jurisdiction in-

(iii) the taxpayer first became subject to such tax after the action taken by the taxing jurisdiction took effect, and

(iv) for a continuous period of one or more taxable years which begins with the first taxable year in which the taxpayer was subject to such tax, the taxpayer consistently accrued such tax in the year in which it would have accrued without regard to section 461(d)(1) of the Internal Revenue Code of 1954,

then the taxpayer may make an election under this paragraph to have section 461(d)(1) of such Code not apply with respect to such action by the taxing jurisdiction for such continuous period. The taxpayer may make an election under this paragraph with respect to only one such continuous period.

(B) If a taxpayer's election under this paragraph applies to a continuous period which ends with the taxable year immediately preceding the first taxable year for which the election described in subparagraph (A)(i) applies, such taxpayer shall not be required to establish a suspense account under section 461(h)(2) of such Code by reason of the election described in subparagraph (A)(i).

(C) An election under this paragraph shall be made at such time and in such manner as the Secretary of the Treasury or his delegate shall by regulations prescribe, except that the approval of the Secretary of the Treasury or his delegate to the making of such an election may not be required.

Summary and Description

PRESENT LAW

Under the accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount of the deduction can be determined with reasonable accuracy. However, present law also provides that, if a taxing jurisdiction changes the time for imposing a deductible tax so that the tax would be deductible in an earlier period under the above rule, an accrual basis taxpayer may not deduct the tax in the earlier period. Instead, the taxpayer may deduct the tax in the period that the tax would have otherwise been deductible if the taxing jurisdiction had not changed the time for imposing the tax.

This provision was enacted to prevent taxpayers from getting two tax deductions in one year because the taxing jurisdiction accelerated the assessment date of a tax. Thus, if a property tax lien date was January 1, of each year and in 1980 the local tax jurisdiction changed the lien date for 1981 and all years thereafter to December 31, the taxpayer would get two tax deductions in 1980—one for the January 1, 1980 lien which was not changed and one for the December 31, 1980 lien date which was changed from January 1, 1981. In this situation, present law would require that an accrual basis taxpayer ignore the change of lien dates and accrue a deduction in accordance with the law before the change, i.e., January 1, 1981.

ISSUE

The issue is whether a taxpayer should be allowed a deduction for taxes where the liability date of the tax has been changed, but the possibility of deductions for two years' taxes is removed through use of a suspense account.

EXPLANATION OF THE BILL

The bill would allow a taxpayer to elect to accrue a deduction for taxes where the liability date of the tax (i.e., the date the tax is accrued under Federal income tax accounting principles) has been changed to an earlier date ("postchange tax") by the appropriate tax jurisdiction. However, the bill still eliminates the possibility of two tax deductions in the year of change by not allowing the taxpayer to deduct the tax that accrues in the year of change or, if greater, the tax in one of the two preceding taxable years (see discussion below) under the law of the taxing jurisdiction before the change in the liability date ("prechange tax"). For example, in the illustration in *Present Law*, the taxpayer would be allowed to deduct the tax having the lien date of December 31, 1980 and would not be allowed to deduct the tax with the lien date of January 1, 1980.

The denial of the deduction for the pre-change tax is accomplished through a suspense account. A suspense account is an account that records the expenditure for the tax but not in an expense account. Under the bill the greater of the pre-change tax or the tax accrued in either of the two preceding years is placed in a suspense account. If the prechange tax is the greater tax and is thus entered in the suspense account it results in a denial of a deduction for that tax. If the tax in one of the two preceding taxable years in the greater tax and is thus entered in the suspense account, it results in a denial of a deduction to the extent of the pre-change tax and in an inclusion in income of the excess of the greater tax over the pre-change tax in order to offset the deduction of the greater tax in the earlier year.

The bill also provides that the suspense account will be reduced if the tax deduction in any of the post-change years is less than the amount in the suspense account. The effect of this reduction will be to allow a deduction for the amount of the reduction. (If the tax under consideration is an income tax, then the reduction in the suspense account, and the resulting deduction, is calculated using the greater of the tax deduction for the current year or the deduction for either of the two preceding years.) However, if the amount of any subsequent tax liability exceeds the amount of the suspense account the amount of that excess will be added to the suspense account until the amount in the suspense account equals the amount originally entered in the suspense account. The amount of the addition to the suspense account is treated as income for that year.

The bill also provides that if a taxpayer has never been liable for a pre-change tax in the taxing jurisdiction but has only been liable for post-change taxes, then the taxpayer will not have to establish a suspense account but may accrue the post-change tax on the new liability date. This would occur in a situation where a corporation is organized after the liability date of a tax is changed so that there is no chance that it could accrue two tax deductions in one year.

The election under this bill can be made for any taxable year if made within the time period prescribed for filing the tax return for that year (including extensions). Although the manner of making the election is to be prescribed by the Secretary in regulations, the election does not have to be made with the consent of the Secretary. The election will be binding for the taxable year in which it is made and for all subsequent taxable years unless the taxpayer secures the consent of the Secretary to revoke the election.

The bill also directs the Secretary to prescribe regulations which treat taxes that are enacted as a substitute for a substantially similar tax as the same tax. Also, nonrecognition transactions unde Subchapter C of the Code are to be dealt with in regulations.

EFFECTIVE DATE

The bill would apply only to the actions of taxing jurisdictions taken after the date of enactment of this bill. However, if the taxpayer makes an election within his first or second taxable year after the bill's date of enactment with respect to an income tax (or a franchise tax based on income) which the taxpayer first became subject to after the change of the liability date and he has consistently accrued the tax deduction on the new liability date, then the taxpayer could elect to continue accruing the tax deduction on the new liability date. Also, the taxpayer does not have to establish a suspense account. Essentially, this election allows taxpayers who were never subject to the pre-change tax, and thus would not have gotten two tax deductions in one year, to continue to deduct the tax on the new liability date. Thus, in this case the effective date of this bill would be retroactive to the date the taxpayer first became liable to the post-change tax.

REVENUE EFFECT

It is estimated that this bill would reduce fiscal year receipts by $54 million in 1982, $111 million in 1983, $124 million in 1984, $136 million in 1985 and $150 million in 1986.

Exclusion of Certain Foreign Commodity Income as Foreign Personal Holding Company Income

97TH CONGRESS
1ST SESSION

H. R. 3581

To amend the Internal Revenue Code of 1954 to exclude certain foreign commodity income from treatment as foreign personal holding company income.

IN THE HOUSE OF REPRESENTATIVES

MAY 13, 1981

Mr. RUSSO introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to exclude certain foreign commodity income from treatment as foreign personal holding company income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (4) of section 954(c) of the Internal Revenue Code of 1954 (defining foreign personal holding company income) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(D) dividends received from a related person which is a controlled foreign corporation out of the earnings and profits of such person for a taxable year in which at least 80 percent of its gross income (other than gross income taken into account in determining the amounts described in section 952(a)) was derived from the purchase or sale of agricultural commodities which were not grown in the United States in commercially marketable quantities (within the meaning of subsection (d)(1))."

(b) The amendments made by subsection (a) shall apply to taxable years of foreign corporations beginning on or after January 1, 1980, and to taxable years of United States shareholders within which or with which such taxable years of such foreign corporations end.

Summary and Description

PRESENT LAW

In the Revenue Act of 1962, Congress enacted legislation intended to tax certain income of tax haven corporations established by U.S. taxpayers. Before this legislation a U.S. taxpayer could engage in business outside the United States through a foreign tax haven corporation and not pay U.S. tax on that income until the corporation paid a dividend to the U.S. shareholder.

Under legislation enacted in 1962 (secs. 951 through 964), U.S. shareholders of controlled foreign corporations are subject to current taxation on their proportionate share of certain categories of undistributed profits from tax haven activities and other activities of the controlled foreign corporation. Foreign taxes paid on that income can be credited against any U.S. tax imposed. This income ("subpart F income") includes certain sales income where the property is sold to or purchased from a related person. It also includes foreign personal holding company income. Dividends and other passive income are considered foreign personal holding company income. Generally, a dividend received by a controlled foreign corporation is treated as subpart F income taxable to the U.S. shareholders even if the paying corporation's income is not subpart F income.

In 1976, these anti-tax haven provisions were amended to exclude from taxation income of a controlled foreign corporation from the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities.

ISSUES

The issue presented is whether dividend income of a foreign subsidiary of a U.S. corporation should be excluded from the general rule treating dividends as personal holding company income taxable to the subsidiary's U.S. parent because the distributing corporation's income is not taxed to the U.S. parent because it is from the sale of agricultural products not grown in the United States in commercially marketable quantities.

EXPLANATION OF THE BILL

Dividends received by a controlled foreign corporation from a related controlled foreign corporation 80 percent of the gross income of which is derived from the purchase or sale of agricultural commodities which were not grown in the United States in commercially marketable quantities will not be considered foreign personal holding company income. Thus, if these agricultural products are purchased and sold by a controlled foreign corporation and that corporation pays a dividend to a related controlled foreign corporation, the dividend will not be considered foreign personal holding company income and will not be subject to U.S. taxation.

It is understood that Consolidated Foods is the primary beneficiary of this amendment although other similarly situated taxpayers could be affected.

EFFECTIVE DATE

The provisions of the bill would apply to taxable years of controlled foreign corporations which begin on or after January 1, 1980 and will also apply to taxable years of U.S. shareholders within which or with which the taxable years of the controlled foreign corporation end.

REVENUE EFFECT

The revenue effect of the bill on budget receipts is not known at this time.

86-375 O - 82 - 10

Refunds of Excise Tax on Buses

97TH CONGRESS
1ST SESSION

H. R. 4408

To amend the Energy Tax Act of 1978 to allow certain additional refunds relating to the repeal of the excise tax on buses.

IN THE HOUSE OF REPRESENTATIVES

AUGUST 4, 1981

Mr. SCHULZE (for himself, Mr. VANDER JAGT, Mr. BRODHEAD, and Mr. HEFTEL) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Energy Tax Act of 1978 to allow certain additional refunds relating to the repeal of the excise tax on buses.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subparagraph (C) of section 231(c)(2) of the Energy Tax Act of 1978 (relating to refunds with respect to certain consumer purchases) is amended by striking out "the first day of such 10th calendar month" and inserting in lieu thereof "December 31, 1982".

(b) Subparagraph (A) of section 231(c)(2) of such Act is amended by inserting before the semicolon ", or, in lieu of evidence of reimbursement, he makes such reimbursement (including any interest thereon as provided in paragraph (4)) simultaneously with the receipt of such a refund or establishes an arrangement satisfactory to such Secretary which assures such simultaneous reimbursement".

(c) Subsection (c) of section 231 of such Act is amended by adding at the end thereof the following new paragraph:

"(4) INTEREST PAYABLE IN CERTAIN CASES.—

"(A) IN GENERAL.—In the case of an eligible claim, paragraph (1) shall be applied without regard to the phrase '(without interest)' if the manufacturer, producer, or importer pays the interest received from the Secretary of the Treasury to the ultimate purchasers of the tax-repealed articles in proportion to the amount of tax paid by such purchasers.

"(B) DATE OF OVERPAYMENT.—In the case of an eligible claim, the date of the overpayment shall be September 1, 1979.

"(C) ELIGIBLE CLAIM.—For purposes of this paragraph, the term 'eligible claim' means any claim for credit or refund which was filed with the Secretary of the Treasury before September 1, 1979, but which was not allowed or made solely by reason of the failure to make reimbursement of the tax to the ultimate purchasers before September 5, 1979.".

Summary and Description

PRESENT LAW

Present law imposes no manufacturers excise tax on buses sold by a manufacturer, producer or importer (Code sec. 4063(a)(6)). The 10-percent manufacturers excise tax on buses which had been imposed under prior law was repealed by the Energy Tax Act of 1978 for buses sold after November 9, 1978.

The Act also contains provisions which effectively allow, under certain conditions, exemption from the excise tax for a bus sold to an ultimate purchaser after April 19, 1977, and before November 10, 1978. Under these provisions, a manufacturer, producer, or importer is allowed a credit or refund (without interest) for the tax paid on a bus if—

(1) he possesses evidence of sale to the ultimate purchaser and of reimbursement of tax to that purchaser;

(2) he files a claim for credit or refund with the Secretary of the Treasury before September 1, 1979; and

(3) the ultimate purchaser is reimbursed before September 5, 1979, for the tax paid on the bus.

ISSUE

The principal issue is whether the refund provisions should be broadened to allow refunds up to January 1, 1983, where the taxpayer was not eligible for the refund under the present rules because the taxpayer had not reimbursed the ultimate purchaser. A subsidiary issue is whether interest should be allowed on such refunds where the interest is passed on to the ultimate purchaser.

EXPLANATION OF THE BILL

In general, the bill would amend the Energy Tax Act of 1978 to broaden the conditions under which a manufacturer, producer, or importer is eligible for a credit or refund of the manufacturers excise tax paid on a bus that was sold to an ultimate purchaser after April 19, 1977, and before November 10, 1978. However, the bill would not amend the present law requirement that a manufacturer have filed a claim for credit or refund with the Secretary of the Treasury before September 1, 1979.

Under the bill, the date before which the ultimate purchaser must have been reimbursed would be extended from September 2, 1979, to January 1, 1983. Second, the bill would allow a manufacturer to reimburse an ultimate purchaser simultaneously with the manufacturer's receipt of a refund of tax from the Treasury, in lieu of the present law requirement that the manufacturer possess evidence of reimbursement. Third, in the case of an "eligible claim," interest would be paid by the Treasury on an amount credited or refunded to a manufacturer (as if an overpayment had been made on September 1, 1979), if the manufacturer pays the interest received to the ultimate purchaser. For this purpose, an eligible claim would mean any claim for credit or refund which was filed before September 1, 1979, but which was not allowed or made solely by reason of the failure to make reimbursement of the tax to the ultimate purchaser before September 5, 1979.

It is understood that certain customers of Harbison Ford, Inc., of Morrisville, Pennsylvania, would be the principal beneficiaries of the bill, although there may be additional beneficiaries.

EFFECTIVE DATE

The introduced bill does not contain an effective date.

REVENUE EFFECT

It is estimated that this bill would reduce budget receipts by less than $1 million for the fiscal years 1982 and 1983.

Expiration of the Deferral of the Effective Dates Relating to Special Limitations on Net Operating Loss Carryovers of Corporations (Code sec. 382)

There have been no bills introduced to extend the effective dates.

Summary and Description

PRESENT LAW

Prior to enactment of the Tax Reform Act of 1976, generally, if new owners purchased 50 percent or more of the stock of a loss corporation during a two-year period, the corporation's loss carryovers from prior years were allowed in full only if the corporation continued to conduct its prior trade or business or substantially the same kind of business. Generally, if the same business was not continued, however, loss carryovers were completely lost. This "purchase" rule applied where one or more of the 10 largest shareholders increased their stock ownership, within a two-year period, by 50 percentage points or more in a transaction in which the purchasers took a cost basis in their stock (except where the stock was acquired from "related" persons).

In the case of a tax-free reorganization, loss carryovers were allowed on a declining scale. If the former owners of the loss company received 20 percent or more of the fair market value of the stock of the acquiring company, the loss carryovers were allowed in full. For each percentage point less than 20 which the former owners received, the loss carryover was reduced by five percent. It was immaterial whether the business of the loss company was continued after the reorganization.

The 1976 Act extensively revised the Code provisions dealing with the carryover of net operating losses in cases of acquisitions of loss corporations. The limitations on loss carryover attributes were to apply to acquisitions made by purchase or through corporate reorganizations. The new provisions changed the basic concepts underlying the rules by deleting continuity of business requirements for purchases and establishing a new continuity of ownership test applicable to both purchases and reorganizations.

These new provisions were to apply to plans of reorganization adopted on or after January 1, 1978, and to sales or exchanges in taxable years beginning after June 30, 1978. However, the Revenue Act of 1978 extended these effective dates to January 1, 1980, and June 30, 1980, and Public Law 96-167 again extended them until January 1, 1982, with respect to plans of reorganization adopted on or after that date, and until June 30, 1982, with respect to sales or exchanges occurring in taxable years beginning after that date. These delays of the effective dates of the 1976 Act provisions were adopted to give Congress additional time to review a number of technical problems as well as to consider additional revision of the rules.

ISSUES

The principal issue is whether the 1976 Act provisions limiting net operating loss carryovers should be permitted to become effective in 1982 under the effective date provisions of existing law; and, further, if so, whether there should be technical revision of these provisions. Alternative solutions are to continue the existing limitations of section 382 permanently or to again continue them for a limited period of time during which other approaches can be considered.

REVENUE EFFECT

It is estimated that allowing the 1976 Act amendment to become effective would increase budget receipts in light of the reduced offset of past losses against current profits. However, the amount of the revenue increase is considered indeterminate because the amount of the reduction in the use of carryovers depends on the relative sizes of the companies involved and also on the extent to which some acquisitions of loss companies by profitable companies may not be made.

SECTION OF TAXATION,
AMERICAN BAR ASSOCIATION,
Washington, D.C., November 25, 1981.

Hon. DANIEL ROSTENKOWSKI,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: The Section of Taxation of the American Bar Association favors further deferral of the application of amendments to sections 382 and 383 of the Internal Revenue Code enacted as part of the Tax Reform Act of 1976. Section 6 of H.R. 4961, as ordered reported by the Ways and Means Committee on November 19, 1981, meets these objectives.

As the attached memorandum demonstrates, sections 382 and 383, as currently scheduled to become effective, include a number of technical defects which have not been corrected, despite deferral of effective dates since 1978. Present law in place works satisfactorily pending correction.

The Section of Taxation is currently studying alternatives which will more effectively reform sections 382 and 323 [sic]. We urge that the Treasury do likewise so that Congress will be presented with substantive proposals rather than a request for further extension in 1983.

The views expressed above are those of the Section of Taxation of the American Bar Association and should not be construed as representing the position of the Association.

Respectfully,

Enclosure.

JOHN S. NOLAN, *Chairman.*

SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION

November 24, 1981.

MEMORANDUM

Re deferral of new section 382.

When Congress enacted the Tax Reform Act of 1976, it completely revised section 382 of the Internal Revenue Code. This new section 382 was originally to become effective in 1978, but the effective date was postponed to 1980, and then to 1982.

There are many technical defects in new section 382. These defects have been illustrated and criticized in several articles on new section 382. Other commentators have questioned the need for the substantial addition to complexity which new section 382 would cause. Still others believe that some of the substantive changes which new section 382 would make are ill-advised and will ultimately be counterproductive. In short, new section 382 needs a great deal of study and reconsideration before it becomes a permanent part of the Internal Revenue Code.

A further deferral of the effective date of new section 382 is justifiable for several reasons. First, this is not a situation where emergency legislation is needed to repair an erroneous or harmful Code section. On the contrary, section 382 has been quite workable. In the first 25 years of its existence, section 382 has generated only one real controversy—the question of when the loss corporation has continued to carry on a trade or business "substantially the same as" that conducted before the ownership change began. Internal Revenue Code section 382(a)(1)(C). And even when that issue has gone to litigation, it has usually produced decisions which are logical and equitable.

Second, old section 382 has not produced an unreasonable amount of litigation. Aside from the trade or business test issue, most of the provisions of old section 382 are simple and straightforward. (Can the same be said of new section 382?)

Third, old section 382 is not a source of any glaring loopholes. The trade or business test is not a loophole when it requires a continuation of the loss business, and even this provision is "safeguarded" by the Commissioner's discretionary weapon of section 269. The revenue loss from continuation of old section 382 is estimated to be relatively small. See Joint Committee Staff Explanation of the Revenue Act of 1978.

The current, uncertain state of Section 382 is a hindrance to business transactions. Practitioners are already cognizant of the technical and substantive defects in new section 382. Correction of these defects is inevitable and the certainty of those corrections makes effective planning impossible even if new section 382 were allowed to become effective. In the meantime, the state of the law on net operating loss carryovers is confused. Business people and their advisors need to know the laws in order to intelligently plan transactions.

It makes little sense to allow an admittedly defective statute to become law. Time is needed for a more careful study of the whole area of limitations on net operating loss carryovers. This is why we urge an additional two year deferral of the effective date of new section 382.

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October 30, 1981

Honorable Fortney H. Stark
Chairman, Subcommittee on Select
Revenue Measures
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Postponement of Effective Date For Special Limitations on Net Operating Loss and Tax Credit Carryovers

Dear Mr. Chairman:

The Tax Reform Act of 1976 amended sections 382 and 383 of the Internal Revenue Code to place stricter limits on the ability of corporations to claim the benefit of net operating loss carryovers, investment tax credit carryovers, and other favorable tax attributes after the occurrence of certain events -- notably, a sufficient change in the identity of their stockholders. Because of persisting doubts about the wisdom and the administrative feasibility of the 1976 amendments, they have not yet been allowed to take effect, and this Subcommittee currently has before it legislation which would delay the effective date of the 1976 amendments for another two years.

The Assistant Secretary of the Treasury for Tax Policy, John E. Chapoton, in testimony before this Subcommittee on October 19, 1981, stated that the Treasury Department supported a two-year deferral of the effective date of the 1976 amendments. The purpose of this letter is to express our support for a two-year deferral. We strongly believe that deferral is needed to prevent the far-reaching -- and in our view erroneous -- amendments of the 1976 Act from becoming law without an adequate examination of the underlying policy issues and their likely economic effect.

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A. Neither Congress Nor the Treasury Has Adequately Examined the Complex Issues Involved In Limitations on Loss and Credit Carryovers.

Prior to 1976, section 382 limited the carryover of net operating losses and tax credits in two general situations[1]: first, where new investors purchased more than 50 percent of the stock of a corporation with existing net operating loss and tax credit carryovers and failed to continue the corporation's historic business; and second, where a corporation with existing net operating loss and tax credit carryovers became a party to a reorganization (other than a stock-for-stock "B" reorganization) in which its historic stockholders ended up owning less than 20 percent of the fair market value of the stock of the acquiring corporation. Section 382 thus served to augment the more general provisions of section 269, which permit the Commissioner to disallow net operating loss deductions and other tax benefits following stock or asset acquisitions motivated principally by tax avoidance or evasion. Together, these provisions "represent an attempt to distinguish between normal changes in the ownership of a going business, where tax attributes such as a net operating loss carryover are incidental, and an acquisition chiefly for the sake of loss carryovers themselves."[2]

The 1976 Act made extensive amendments to section 382. Most importantly, the 1976 Act would impose a single test -- change in stock ownership -- to determine the carryover of net operating losses and tax credits. In general, a more than 60 percent change in stock ownership, whether by purchase or in a tax-free reorganization, would cause a reduction of net operating losses and tax credits according to a sliding scale. The continuation of the business which originally generated the losses and credits would no longer serve to preserve net operating loss carryovers or tax credits.

The 1976 amendments to section 382 were both sweeping and complex, yet they were enacted after only minimal consideration by the Congress. Not included in the version of the legislation

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1. The substantive rules of section 382 governing net operating loss carryovers are incorporated by reference in section 383, dealing with carryovers of investment tax credits, foreign tax credits, and other tax attributes, so for simplicity this discussion will focus on section 382.
2. S. Rept. No. 94-938, 94th Cong., 2d Sess. 201 (1976) (the "Senate Report").

reported by the House Ways and Means Committee and approved by the House of Representatives, and never considered at hearings in either the House or the Senate, the proposal to amend section 382 first surfaced in the Senate Finance Committee. The far-reaching amendments adopted by that Committee were refined somewhat by the Conference Committee which, perhaps in recognition of the absence of public debate which had preceded these amendments, deferred the effective date of the new rules for one year in order "to allow a reasonable time for the Internal Revenue Service to issue regulations under the new rules."[3]

Five years have passed, and the Internal Revenue Service has yet to issue, or even propose, regulations implementing the amended version of section 382. In the meantime, doubts about the wisdom and technical feasibility of the amendments have led Congress to delay the effective date of the amendments twice, first to 1980 and most recently to 1982. The new rules are now set to become effective for reorganizations pursuant to plans adopted on or after January 1, 1982, and for purchases of stock in taxable years beginning after June 30, 1982.

Evidently, neither Congress nor the Treasury has a satisfactory solution to the complex issues involved in this matter and for that reason a further two-year delay in the effective date of the 1976 amendments is imperative. More fundamentally, however, it is our judgment that the 1976 amendments to section 382 should never be allowed to become law.

B. The 1976 Amendments Are Fatally Flawed.

The Senate Finance Committee in 1976 recommended amendment of section 382 in order to prevent "trafficking" in loss carryovers and other tax avoidance gimmicks. The amendments have been widely criticized, and we also view them as misguided. Without detailing the many technical criticisms, we would like to stress two major policy flaws.

1. The Stated Rationale of the 1976 Amendments is Wholly Unpersuasive.

The genesis of the 1976 amendments to section 382 is perhaps best understood by examining the title of the section of the Senate Finance Committee report devoted to these amendments: "Trafficking

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3. H.R. Rept. No. 94-1515 (Conference Report), 94th Cong., 2d Sess. 450 (1976).

in Net Operating Loss Carryovers."[4] The Committee believed that section 382, even in conjunction with section 269, was ineffective in preventing the use of net operating losses as a major tax shelter, and for that reason undertook to "prevent abuse" and "close loopholes" by restricting the potential of section 382 for manipulation and abuse. The Senate report elaborates on these concerns as follows:

> Present law recognizes, in effect, that tax attributes of a going business may have some financial bearing on the negotiations for a sale ot stock or for a merger. The difficulty, however, is that any rules which permit an operating loss to continue despite a sizable change in shareholders or a merged business can in many cases be manipulated for tax avoidance purposes. For example, a free traffic in loss carryovers could result in large windfalls for buyers of stock or assets, who could take advantage of the weak bargaining position of the existing owners of a loss business and acquire large carryovers for only a few cents on the dollar. Such buyers are effectively buying a tax shelter for their expected future profits, whereas if the same persons had used their capital to start a new business on their own, no such loss offsets would be available.

The Committee also thought section 269, although of some utility "in discouraging obvious tax avoidance transactions," was an inadequate safeguard because of the need to inquire into a taxpayer's subjective motivations.

There appear to be two strains to the Committee's concerns, neither of which is supported by available data. First, present law was viewed as a major loophole. However, there is little hard evidence that losses were being shifted around so freely, and the government has had little trouble in convincing the courts to disallow loss carryovers in abuse cases.[5] It should be noted, too, that the consolidated return regulations also limit the potential manipulation of loss and credit carryovers. Moreover, the magnitude of this abuse is belied by the revenue estimates; each time Congress

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4. The discussion of section 382 appears at pages 200-207 of the Senate Report.
5. See, e.g., Vulcan Materials Company v. United States, 446 F.2d 690 (5th Cir. 1971), cert. den. 404 U.S. 942 (1971); PEPI, Inc. v. Commissioner, 448 F.2d 141 (2d Cir. 1971); Swiss Colony, Inc. v. Commissioner, 428 F.2d 49 (7th Cir. 1970).

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has delayed the effective date of new section 382, the cost to the Treasury has been estimated at less than $5 million per year, an amount which is virtually negligible and belies the existence of a problem in need of a major revision.[6]

The Committee was also concerned that the owners of loss corporations were not receiving adequate compensation for their loss carryovers and that the buyers were able to obtain "large windfalls." However, it is obvious that the position of the owners of loss corporations would be much improved by eliminating restrictions on the availability of loss carryovers rather than increasing them.

2. The 1976 Amendments Drastically Undercut Congress' Long-Standing Policy of Encouraging Investment Through Tax Incentives.

Since 1954, a large number of incentives have been written into the Internal Revenue Code to encourage various types of activity -- notably, investment in equipment and other productive tangible assets, but also research, oil exploration, energy conservation, and many others. Many of these incentives operate by reducing companies' stated taxable income and, in some cases, producing a "tax loss" for a company even though it is economically healthy. This is true, for example, of deductions for accelerated depreciation, research and experimentation, and intangible drilling costs. Other incentives operate by granting a direct credit against a company's federal income tax bill -- for example, the investment tax credit enacted in 1962.

The point is that a significant portion of the unused losses and tax credits which are potentially subject to reduction or elimination under section 382 are traceable to Congress' policy of encouraging investment and other activities through tax incentives. That policy is eroded if the incentives are withdrawn merely because a business-motivated acquisition causes a change in the underlying ownership prior to the anticipated stream of income. Stated differently, the investment incentives provided by Congress are of paramount importance to our economic recovery and should not be undercut except in clear and compelling circumstances -- and routine, business-motivated changes in ownership clearly do not rise to the level of compelling circumstances.

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6. S. Rept. No. 95-1263, 95th Cong., 2d Sess. 190 (1978); S. Rept. No. 96-433, 96th Cong., 1st Sess. 13 (1979).

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C. Developments Since 1976 Require a Fresh Look at the Carryover Problem.

Five years have passed since the enactment of the 1976 amendments, and during those years a number of important developments have occurred which cast further doubt on their wisdom.

1. Economic Strains and Acquisition Activity.

Many businesses experiencing net operating losses are by no means economic failures. A basically sound company may go through periods of prolonged losses as it adjusts to changing market conditions -- particularly when ordinary competitive forces are exacerbated by government intervention, prolonged inflation, and economic stagnation. In addition, companies in all lines of business have been hit by unprecedented double-digit interest rates since 1976 which have seriously reduced profits and driven many marginal companies into the red.

Even if interest rates are finally brought under control, the road to recovery is going to be tough. Many companies will require large infusions of new capital, and some will survive only by joining forces with other healthier businesses -- a factor reflected in the recent surge of mergers and takeovers. The 1976 amendments stand in the way of recovery because they eliminate loss and credit carryforwards solely on the basis of changes in ownership, without regard to business exigencies and sound economic policy.

2. The Economic Recovery Tax Act of 1981.

The Economic Recovery Tax Act of 1981 made at least two major changes in the Internal Revenue Code which counsel against limitations on loss and credit carryovers such as those contained in the 1976 amendments.

First, the 1981 Act inaugurated a completely new system of depreciation for tangible assets designed in general to reduce the period during which a business can recover for tax purposes the cost of its depreciable assets. This new Accelerated Cost Recovery System includes relaxed leasing rules intended to make it easier for companies which are not themselves in a position to benefit from increased depreciation deductions and investment tax credits, to shift those tax benefits to profitable companies which can use them. Nonetheless, as with other capital formation incentives, the effect of this new Accelerated Cost Recovery System would be seriously dampened by imposition of the strict 1976 limitations on loss carryovers.

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The 1981 Act also extended to 15 years the period during which most companies can carry forward their net operating losses. The extension of the carryforward period should therefore reduce the need for limitations of the sort provided by section 382 by encouraging struggling companies to maintain the fight.

3. Post-enactment Commentary.

While the 1976 amendments to section 382 were conceived late in the legislative process and were never subjected to the public scrutiny which normally precedes such major Congressional initiatives, they have subsequently received widespread criticism. A number of alternative proposals have been published which clearly reject the stock ownership approach embodied in the 1976 amendments.[7]

Some commentators continue to advocate no restrictions at all, thus allowing free transferability of loss and credit carryovers. Significantly, the proposals which advocate some restrictions (but less than the 1976 restrictions) have proceeded partly from an assumption that free transferability is politically unacceptable -- an assumption which must be reexamined in the aftermath of the 1981 Act. Obviously, a fresh look at the alternatives is needed before a reasoned decision can be made as to what, if any, restrictions should be placed on the carryover of losses and credits following a substantial change in stock ownership.

Conclusion

In 1978 and again in 1979, Congress delayed the effective date of the 1976 amendments to sections 382 and 383, and the Committee reports justified the delay on the ground that "a number of technical problems concerning the 1976 revisions have been brought to the Committee's attention [and] an additional period of time is necessary to complete a review of the provision."[8] We are pleased that Assistant Secretary Chapoton, in his testimony before the Subcommittee, frankly admitted that the problem may be both technical and substantive, and that the Treasury Department "has not yet determined what limitations, if any, it believes should be imposed on the ability of a corporation to use net operating loss carryovers and credit carryovers in taxable years after a

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7. See, e.g., Aidinoff, Utilization of Acquired Net Operating Loss Carryovers and the Tax Reform Act of 1976 -- A Face-Lift for Section 382, 55 Taxes 874 (Dec. 1977); New York State Bar Association, Report on Section 382 of the Internal Revenue Code as amended by the Tax Reform Act of 1976, 31 Tax Lawyer 283 (1977).
8. S. Rept. No. 95-1263, 95th Cong., 2d Sess. 189 (1978); S. Rept. No. 96-433, 96th Cong., 1st Sess. 13 (1979).

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substantial change in the identity of a corporation's stockholders."

This is an appropriate time to give the 1976 amendments an intensive, full-scale review. The stakes are high, and the years since 1976 have brought both economic and tax policy changes, as well as significant professional commentary, which cast doubt on the wisdom of the 1976 approach.

The substantive and administrative flaws in the 1976 amendments to sections 382 and 383 are simply too great to allow them to begin to take effect this coming January. However, in the interest of moving toward a permanent solution, we also recommend that the Treasury be requested to submit a report to Congress containing its recommendations on the loss and credit carryover problem.

Respectfully submitted,

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CABLE "TAXLAW"

October 21, 1981

Mr. John J. Salmon
Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Sir:

I am a tax attorney with thirty years of experience in the Federal income tax field and am familiar with the provisions of Sections 381 and 382 which have been amended, but which amendments have not been made effective until December 31, 1981 and June 30, 1982 respectively.

I believe the amendments do not represent good tax policy and are too restrictive in the utilization of net operating losses. Accordingly, I believe the effectiveness of the amendments should be further postponed until a whole review of the subject matter can be made.

Sincerely,

Milton A. Levenfeld

MAL/vds

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October 29, 1981

The Honorable Fortney H. (Pete) Stark, Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Stark:

On behalf of the Tax Section of the New York State Bar Association, I urge the postponement for two years of the effective date of the special limitations on net operating loss carryovers, under section 382 of the Internal Revenue Code, which were enacted in the Tax Reform Act of 1976.

The amendments to section 382 effected by the Tax Reform Act of 1976 were enacted with little or no public discussion and with no serious public consideration of the basic premise that drastic new legislation was necessary to limit "trafficking" in loss carryovers. Congress recognized the need for further consideration of these amendments by extending the effective date in 1978 and again in 1979. Unless Congress takes action to further extend the effective date, these provisions will become applicable to plans of reorganization adopted after December 31, 1981, and to sales or exchanges of stock in taxable years beginning after June 30, 1982. Despite the previous extensions, the press of other business has prevented Congress from undertaking a full study of the area and a further extension should therefore be enacted.

I enclose for your consideration a report of August 10, 1977, by a subcommittee of our Committee on Corporations, on section 382 as amended by the Tax Reform Act of 1976. The conclusions are

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summarized at pages 33-36. We believe that no compelling reasons have been demonstrated for replacing section 382 as it existed before the Tax Reform Act of 1976 with provisions of increased length and complexity. Further, we believe that fresh consideration should be given to whether it is necessary or desirable to limit the transfer of the carryovers covered by section 382. The enclosed report also makes some technical recommendations for consideration if it is concluded that there should be limitations and that section 382 as it existed before the Tax Reform Act of 1976 is not adequate.

Sincerely yours,

Ruth G. Schapiro

Ruth G. Schapiro
Chairman

RGS:jb
Enclosure

cc: The Honorable Robert J. Dole
The Honorable Russell B. Long
The Honorable Daniel Patrick Moynihan
The Honorable Daniel Rostenkowski
The Honorable Barber B. Conable
The Honorable Charles B. Rangel
The Honorable Thomas J. Downey
The Honorable Roscoe L. Egger, Jr.
The Honorable John H. Chapoton
Mark L. McConaghy, Esq.

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON CORPORATIONS

Report on Section 382 of the Internal Revenue Code as Amended by the Tax Reform Act of 1976

August 10, 1977

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Appendix A

I. Introduction

This report is designed primarily to make recommendations for the revision of Section 382 of the Internal Revenue Code as amended by the Tax Reform Act of 1976.* The bulk of this report accepts the basic policy judgment that tightening restrictions on "trafficking" in loss carryovers and other tax benefits is desirable and then discusses methods of improving Section 382 both in basic concept and in important details.

Before proceeding with that task, the Committee wishes to draw attention to the obvious fact that "new" Section 382 was decided upon and enacted with little or no public discussion and particularly with no serious public consideration of its basic premise, i.e., that drastic new legislation is necessary to limit "trafficking" in loss carryovers. We think it appropriate to examine that premise and consider whether new legislation, or indeed any legislation, is necessary in this area.

This report was drafted by a subcommittee chaired by Arthur A. Feder and consisting of Richard H. Nicholls, Willard B. Taylor and Lee S. Parker. The report benefitted from extensive comments by Eugene L. Vogel, Chairman of the Committee on Corporations.

* H.R. 10612, 94th Cong., 2d Sess., Public Law 94-455, section 806(e).

A. Is New Legislation Necessary?

The fundamental premise underlying new Section 382 is that a change in the statutory machinery is necessary to restrict undue trafficking in net operating loss carryovers and other tax benefits. Yet none of the committee reports adduces any facts to demonstrate that there is significant trafficking in carryovers under present law. Moreover, the committee reports state that the revenue effects of these amendments are "uncertain" - which certainly suggests that "trafficking", to the extent it exists, may have no great revenue effects.

In the absence of published statistics showing that any great abuse occurs in this area, we doubt that the enormous addition to the complexity of the Code inherent in doubling the length of Section 382 is worthwhile. We would suggest that doubling the length of a Code provision probably leads to a fourfold increase in the problems of its interpretation. The new statute, even before it has come into effect, is proving a minefield of interpretative problems.* We very much doubt that the extension of the carryover

* See, Association of the Bar of The City of New York, Committee on Taxation, Statement on Section 806(e) of the Tax Reform Act of 1976 (H.R. 10612); Eustice, The Tax Reform Act of 1976, Loss Carryovers and Other Corporate Changes, 32 Tax. L. Rev. 113 (1977).

period from five to seven years creates enough added risk of abuse to justify this additional complexity.

If there is excessive trafficking in the stock of corporations having net operating loss carryovers and other carryovers, we wonder whether this trafficking might not be better dealt with by leaving the previously existing provisions in place but proceeding with a publicly announced approach of "tough" enforcement.

The corporate tax return does not now serve to alert an examining agent to the occurrence of a Section 269 or 382 transaction.* It might be desirable to require a corporation using a net operating loss or other carryover to indicate on its return whether a change of ownership as defined in Section 269 or 382 has occurred. Returns which indicate that such changes have occurred could then be given more intensive scrutiny in the audit selection process.

Present audit procedures might also be tightened by instructions in the audit manual requiring specific answers by agents to a question as to whether the possible

* Question H(2) asks only whether any person or attribution group (using 267(c) rules for this purpose) owns 50 percent or more of the stock of the corporation. This would not serve to alert an agent to the possible occurrence of a Section 269 or 382 transaction.

application of Sections 269 and 382 has been considered wherever a loss or other carryover in excess of some specified amount has been utilized.

In addition, the Service might well adopt a policy of more aggressive audit of any corporate return showing a substantial deduction for a net operating loss carryover. Such returns might be readily selected for audit by computer. We understand that such corporations are frequently ignored for audit purposes so long as the carryovers more than cover present income. Moreover, an examination of the publicly available audit manuals shows little that would lead an agent to be especially alert to this type of transaction. Thus, the question of whether Sections 269 or 382 might be applicable is frequently never raised on audit.

We would suggest that, frequently, a public warning of an aggressive audit policy will do more to limit abuse transactions than any amount of additional legislation, particularly when a fairly rigorous set of restrictions already exists.

B. Should There Be a Free Traffic in Net Operating Loss Carryovers?

Before tightening the restrictions on trafficking in carryovers some consideration should be given to the substantial arguments that can be made for permitting free traffic in net operating loss carryovers. At present,

entrepreneurs who offset losses from one line of business against another existing line of business or against other sources of income in effect receive a Government subsidy for an unprofitable enterprise which is not available to others who cannot so offset their losses. Allowing free transferability of loss carryovers would make the subsidy to all entrepreneurs essentially the same. It would also be a dramatic help for those trying to raise capital for new venture capital businesses.

In fact, an enormous trade in corporate tax benefits now operates through the equipment leasing market, where investment tax credits and accelerated depreciation are transferred to taxpayers better able to utilize such benefits than the lessees of the equipment, apparently with complete Congressional approval. We believe that the annual totals of tax benefits transferred from one corporation to another in that market exceed many times over the tax benefits "trafficked" by sales of stock of loss corporation.

The bias of present law in the net operating loss area may be seen by examining the case of three groups that set out to develop and market a computerized mousetrap, each investing and losing $10,000,000 in the project.

A Corp. is a subsidiary of General Inventions, Inc., which has pretax income of $10,000,000 a year and intends to file a consolidated return.

B Corp. is a corporation which has raised $10,000,000 from a group of fifty investors.

C Corp. is owned by ten wealthy individuals who as a group have taxable income of $5,000,000 a year.

In A's case a loss of $10,000,000 results in an immediate $5,000,000 reduction in tax liability of General Inventions, Inc., in addition to the speculative possibility that some capital gains tax reduction may be obtained at the shareholder level reflecting the $5,000,000 net economic loss.*

B's loss produces only a $10,000,000 capital loss at the shareholder level which is of speculative utility for most taxpayers. Both "new" and "old" Section 382 would severely inhibit any effort to pass B's loss carryover to third parties and, in practical effect, B's shareholders will be out of pocket by the full $10,000,000, without any tax relief.

C's losses are likely to be passed through to its investors pursuant to Subchapter S, and produce tax benefits of between $5,000,000 and $7,000,000.

Is there any sense in a situation in which the investors are in effect able to recoup $5 to $7 million of their investment from the federal coffers in the first and

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* Note also Textron, Inc. v. United States, 77-2 USTC ¶ 9539 (1st Cir. 1977) in which the taxpayer obtained the equivalent of $10,000,000 of tax savings in an analogous situation.

third cases, but not in the second?* Permitting free trade in the stock of corporations having net operating loss carryovers would put all three groups of investors in parallel economic situations.

If there were a free trade in the stock of corporations having net operating loss carryovers, the investors would sell B corporation to a third party or merge it with another corporation. The acquiring person presumably would be willing to pay something approximating 48 percent of the net operating loss carryovers, discounted primarily for the time which would be required to utilize the loss. In effect, free trade in net operating loss carryover corporations would substantially reduce the possibility of "windfalls" for buyers which the "Blue Book"** suggests as the basic reason for the present prohibitions on limitations on transfers of interests in loss corporations. Owners of loss corporations would be able to obtain higher prices on sales of their stock if it were known that the corporation's carryovers were clearly usable.

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* An expansion of Subchapter S to cover corporations with more shareholders is not likely to meet B's problem in view of the complexities of that provision.

** General Explanation of The Tax Reform Act of 1976, 191. This document is cited hereinafter as "Blue Book."

We believe there is much to be said, therefore, for a free trade in the stock of corporations having net operating loss carryovers, and further believe that the possibility of extending this analysis to other carryover items also deserves consideration, particularly since these items seem unlikely to play a major role in shaping transactions for tax avoidance purposes.

II. Substantive Proposals Relating to Limitation of "Trafficking" in Loss Carryovers.

The balance of this Report accepts the basic policy decision that trafficking in losses should be controlled, and that new legislation is necessary. The remainder of this report first makes recommendations for basic changes in Section 382; next considers other areas in which legislation is appropriate as part of an overall approach to the problem of trafficking in losses; and then makes technical and drafting suggestions to improve and simplify Section 382. Finally, Appendix A to this report is a rough draft representing one approach to a simplified and integrated Section 382.

A. Use of Carryovers in the Same Trade or Business.

Prior to the Tax Reform Act of 1976, carryovers were allowed under Section 382(a) unless, in addition to a change in ownership, there was a change in trade or business

(i.e., the corporation did not continue to carry on a trade or business "substantially the same" as that previously conducted). While Section 382(b) did not contain an explicit "trade or business" test, the inapplicability of that provision to "B" reorganizations and the special rules relating to triangular reorganizations can be viewed as incorporating a modified trade or business test, since the effect was to allow the carryover if the assets of the corporation with the carryover remained in a separate corporation which acquired no other major assets in the reorganization. The Tax Reform Act of 1976 eliminated change in trade or business as a criterion under Section 382(a), the exception in Section 382(b) for "B" reorganizations and the special rules under Section 382(b) for triangular reorganizations.

In the Committee's view, a change in the ownership of a corporation should not result in a disallowance of its carryovers under either Section 382(a) or Section 382(b) if there is adequate assurance that the carryover will only be used against tax liabilities generated by the business that gave rise to the carryovers. This rule would be an exception to the general rule that disallows carryovers when there has been the requisite change in ownership. Any difficulty in

policing and enforcing the exception would be handled by requiring the taxpayer to establish that the exception applied and by writing the exception to allow a carryover only if and to the extent used to reduce a tax liability attributable to the same business that gave rise to the carryover (i.e., the exception would be substantially narrower than the discontinuance of trade or business rule in old Section 382(a)).* If in an "A" or "C" reorganization the business with the carryover ended up in a corporation which conducted other businesses, the taxpayer would be required to keep the records necessary to segregate the business of the carryover corporation from that of such other businesses.**

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* The standard of proof imposed would be comparable to that imposed on taxpayers seeking to satisfy the tests of the Libson Shops case under the 1939 Code, to wit:

> Further, the taxpayer has the burden of establishing the correctness of the amount claimed as a net operating loss deduction or unused excess profits credit. Even after a statutory merger or consolidation subject to the 1939 Code, if the records of the resultant corporation are not maintained in such manner as to enable the Internal Revenue Service to make a reasonably conclusive determination as to the part of such deduction or credit allocable to the portion of the business of the resultant corporation conducted with the assets of the merged constituent, the claim will be regarded as having failed for lack of proof and will be disallowed. Rev. Rul. 59-395, 1959-2 C.B. 475, 479.

** An alternative, more limited than that recommended by the Committee, would be to restore the exception under prior law for "B" reorganizations and the special rules for triangular reorganizations in which the corporation with the carryover ends up as a separate corporation with substantially no new assets. This might be simpler to administer, but it would not cover other forms of reorganizations.

B. Section 269.

The legislative history of the Tax Reform Act expresses the intent of Congress that Section 269 not be applied to disallow carryovers allowed under Section 382 "unless a device or scheme to circumvent the purposes of the carryover restrictions [of Section 382] appears to be present".* This expression of intent is substantially diluted, however, by a subsequent statement that the "device" exception will apply "where a permanent interest by the former owners of a loss company is diluted for tax avoidance purposes."**

It is difficult to give meaning to these statements without examples. Suppose, for example, that X corporation, with a substantial net operating loss and insubstantial assets, is merged into Y corporation. Assume that Y is essentially interested in X's loss and that the shareholders of X extract, as the price for such loss, 45 percent of Y corporation's "participating stock" and "stock". The Section 382 limitation is not discussed during the negotiations.

Neither the language nor the legislative history of the Tax Reform Act indicates whether it was intended that the tests of Section 269 should apply to this case or a case in which Y's shareholders receive only 35 percent of Y's "stock" and "participating stock". Moreover, it is not clear whether the answers to these questions would be different if the parties had considered Section 382.

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* Blue Book, 203.
** Blue Book, 203, n. 32.

Unless it is intended that Section 269 be inapplicable in each of these cases, we doubt that the statements in the legislative history have much value. In the Committee's view, the legislative history will simply shift arguments under Section 269 to the issue of whether or not there was a "device" to avoid Section 382. Once a policy decision is reached to limit trafficking in losses, moreover, there is no reason why tax-motivated transactions should be successful simply because they satisfy the requirements of Section 382. Accordingly, the statements in the Blue Book with respect to Section 269 should be disavowed.

Alternatively, the Code itself should be amended to preclude the application of Section 269 to any transaction subject to the tests of Section 382, whether or not that section actually reduces a carryover.*

C. "Non-Linear" Reduction.

Prior to the Tax Reform Act, Section 382(b) reduced carryovers by 5 percent for each percentage point of the surviving corporation's stock under 20 percent that was owned by stockholders of the corporation having carryovers. Section 382(a) eliminated the entire carryover if there was the requisite change in ownership and in trade or business.

* Other recommendations for the amendment of Section 269 are made at page 17.

The Tax Reform Act raised the Section 382(b) percentage from 20 percent to 40 percent and introduced the concept of proportionate reduction under Section 382(a). In each case, the Act provides for a non-linear reduction -- i.e., a 3 1/2 percent decrease in the carryover for the first 20 percentage points under 40 percent and a 1 1/2 percent decrease in the carryover for the second 20 percentage points.

The legislative history* attempts to justify this non-linear reduction by analogy with other provisions of the Code (such as affiliation for consolidated return purposes, Sections 332, 368(c)), all of which put a premium on 80 percent ownership and attach little or no significance to the ownership of the remaining 20 percent of the corporation's stock. It seems to the Committee, however, that analogies with other Code sections are unpersuasive, and that, in terms of the policy of Section 382, there is no good reason to distinguish between the first 20 percentage points and the second. At the same time, the 3 1/2 percent - 1 1/2 percent structure adds complexity. We recommend, therefore, that the reductions in the carryover items be linear (i.e., 2 1/2 percent for each percentage point over 60 percent). Alternatively, we would recommend that available carryovers be reduced at the rate of 3 1/2 percent for each percent of change in excess of 60 percent, even though it would

* Blue Book, 193, n.3.

result in complete disallowance short of a 100 percent change in ownership.

D. Concepts of Control and Common Control in Sections 382(b) and 269.

In general we approve of the attempt to make Sections 382(a) and (b) more closely parallel so that differences in the form of transactions will not result in significant differences in the availability of carryovers. Further improvement should be made, however, in the application of Section 382(b) to multi-tier structures and in the concepts of "control" and common control as used in Section Section 382(b). Moreover, such concepts should be coordinated with those of Section 269.

(1) Section 382(a) limits a net operating loss carryover available at any level of a multi-tiered corporate structure if the requisite change in ownership occurs even indirectly, e.g., if a more than 60 percent change of ownership in the stock of a corporation occurs and its wholly-owned subsidiary or second-tier subsidiary has a net operating loss carryover. Moreover, for purposes of Section 382(a), changes in the ownership of one corporation's stock are relevant in determining whether the requisite change of ownership has occurred with respect to any other corporation in which the first corporation owns any stock, directly or by attribution.

However, the limitations of Section 382(b) apply to a subsidiary of a corporation participating in a reorganiza-

tion only if the acquiring or acquired corporation "controls" the subsidiary. The use for this purpose of the Section 368(c) definition of "control" opens several potentially significant loopholes. If P merges with X, and S, a 78 percent owned subsidiary of P, has a net operating loss carryover, Section 382(b) will have no affect whatsoever on S's net operating loss carryovers. If P has a 100 percent owned second-tier subsidiary, S_2, which has an available net operating loss carryover, a merger of P into X will not reduce S_2's loss carryover.

(2) Under Section 382(a) a transaction which does not result in the requisite change in the beneficial ownership, actual or constructive, of a corporation will not result in a reduction of a net operating loss carryover. Section 382(a)(5)(A).

By contrast, under new Section 382(b), as under prior law, the fact that there is substantial common ownership of two merging corporations by the same group of shareholders does not preclude application of the loss limitations unless "the same persons own substantially all the stock of the acquiring corporation and of the other corporation in substantially the same proportions." Section 382(b)(6)(A).* Similarly, while the common control exception was broadened to make it applicable to reorganizations involving second-

* This exception has been read strictly by the courts. Kern's Bakery of Virginia, Inc., 68 T.C. No. 44 (1977); Commonwealth Container Corp., 48 T.C. 483 (1967), aff'd 393 F.2d 269 (3d Cir. 1968).

tier controlled corporations, if, say, A owns B directly and C through two tiers of subsidiaries, the exception will apparently not apply because the concept of control is too narrow. Such strict limitations cannot be justified in the context of a statute which generally allows a 60 percent change in ownership without limitation of losses.

Both these types of problems (one operating unfairly in favor of taxpayers and the other unfairly against them) could be resolved and Sections 382(a) and (b) brought more closely into parallel by recasting Section 382(b) in terms of a change in actual or constructive ownership. In other words, the limitations would not come into play unless the percentage of shares held by the actual or constructive owners of the loss corporation was reduced to less than 40 percent of the value of the combined corporation. It would be immaterial whether the shares were acquired in the reorganization or were previously held.

Under this approach, Section 382(b) would apply to all levels of a multi-tiered corporate structure. As with Section 382(a), it would be immaterial whether a first tier or a tenth tier subsidiary suffered the loss. Under these circumstances there would be very little need for the consolidated return regulation provisions limiting use of losses in situations involving consolidated return changes

of ownership, reverse acquisitions and acquisitions of an old group by a new group.

(3) Many transactions excepted from the scope of Section 382(a) by Section 382(a)(5) would seem to be subject to the tests of Section 269. The Congressional judgment that loss carryovers should be unaffected by such transactions would be frustrated if Section 269 were applied to such transactions and a sufficiently strong business purpose could not be established. For example, a transaction in which creditors or employees take control of a corporation is free of the restrictions of Section 382(a) but within the possible ambit of Section 269.

Moreover, Section 269 itself contains only very limited common control exceptions. Thus, for example, an upstream merger of subsidiary into parent is free of Section 269, while a downstream merger is not.*

Accordingly, we recommend that constructive ownership rules applicable to Section 382(a) and exceptions paralleling those of Section 382(a)(5) be incorporated into Section 269.

E. Built-In Losses.

The Blue Book states that ". . . Section 269 is retained for example to deal with 'built-in-loss' transac-

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* See Treas. Reg. §1.269-3(c)(2).

tions . . .".* The application of Section 269 to built-in-loss transactions has been uncertain in the past and the legislative history of new Section 382 does not provide much additional guidance. The Committee believes that, assuming a policy decision to limit "trafficking" in losses, the question of built-in losses should be dealt with expressly and that the concepts of Section 382 are appropriate for this purpose.

In our experience, built-in losses are not typically a major factor in the "trafficking" in losses. On the other hand, there are instances in which the tax basis of the assets of a corporation so far exceeds the value attributable to such assets that the ability to continue depreciating at an artificially high level or to dispose promptly of the assets at a large loss may become a significant factor in the transaction. In these extreme cases, it is difficult to distinguish between a loss realized prior to (or within three years of) a change in ownership, which is presently covered by Section 382, and a built-in loss recognized more than three years after that change, to which Section 382 does not now apply.

For purposes of defining built-in losses to which section 382 would apply, it is important to distinguish between those instances in which the built-in losses are so substantial as to be a significant motivation in the transac-

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*Blue Book, 203.

tion, and the more ordinary case where there is some variation between the basis and the value of the assets but the overall impact is not that significant. Accordingly, we would recommend that built-in losses be deemed to arise only in instances where the total consideration attributable to all of the assets acquired is significantly less than their tax basis. The test should not be applied asset by asset. There may be significant variations in value as compared to basis of particular assets, but if, overall, the consideration paid is not very substantially out of proportion to the overall value of the package of assets obtained, tax avoidance motivations are unlikely to play an important role in shaping the transaction.

In addition, and for the same reasons, we believe that the threshold test for built-in losses should be fairly high. We would recommend therefore that built-in losses not be deemed to arise unless the tax basis of the assets is at least 50 percent higher than the value of the consideration attributable thereto.

F. Consolidated Return Regulations.

The Committee believes that the rules of Section 382 and the limitations on losses contained in the consolidated return regulations should be harmonized. Briefly summarized,

the principal limitations in the consolidated return regulations are the following:

(1) Separate Return Limitation Years. With some exceptions, a loss carryover from a separate return year can be applied only against income of the loss member. Loss carryovers arising in years before a corporation became a member of a presently existing affiliated group can be used only against income of that corporation.

(2) Consolidated Return Change of Ownership. If the persons described in Section 382(a) increase their percentage ownership by 50 percent by purchase or redemption, a consolidated return change of ownership occurs. Thereafter, losses of the old group may be used only against income of the old members of the group.

(3) Reverse Acquisition. If one controlled group acquires another, and as a result the shareholders of the acquired group obtain more than 50 percent of the stock of the acquiring group, the acquiring group terminates and any carryovers from an individual member of that group may thereafter be used only against the income of that member.

Similar limitations apply to "built in losses" and other items.

While these provisions can be summarized in simple fashion, their application is complex, and the application

of limitations to particular corporate entities encourages manipulation through the transfer of properties. It appears to the Committee that the tests imposed in these regulations are not consistent with the approach of new Section 382, and should at least be modified so as to be brought in line with that section. More importantly, since Section 382(a) applies at all levels of a multi-tier corporate structure, and if Section 382(b) is amended to so apply and Section 382 is made applicable to "built-in losses", there would appear to be little remaining need for the rather artificial consolidated return regulation limitations described above and they could then be eliminated.

III. Technical and Drafting Suggestions

A. In General

The Committee believes that new Section 382 is unduly prolix and that this prolixity multiplies the potential questions of interpretation that the Section will generate. Moreover, to the extent that the provision is difficult to understand, taxpayers will tend to decide questions of interpretation in their own favor, assuming that the Service will or may fail to discover that a change of ownership has occurred. We fully understand that there simply was no opportunity for more careful drafting in the

short period of time that was available for this purpose in 1976. It is our belief, however, that the statute could be considerably simplified and materially increased in effectiveness by substantial redrafting. An example of one approach to the goal of a simplified statute in draft form is attached as Appendix A.

Part of the price of reducing complexity may be that some potential problems are left unresolved in cases where abuse transactions are logically possible but not probable in practice. Drafting frequently becomes unduly complex when the draftsmen attempt to cover the most extreme possible situations. The effect is not unlike that faced in insulating a building, where a 95 percent reduction in heat loss can be achieved for 2X dollars but a 99 percent reduction may cost 10X dollars. In Section 382 the difference between eliminating 95 percent and 99 percent of potential abuse is at least a doubling of complexity.

For example, the statute is unduly complicated by the additional language introduced to extend Section 382(a) to situations in which there are changes in the ownership of partnerships which own stock in corporations. We question whether the Service has knowledge of any significant number of cases where this technique has been used to avoid the reach of existing law. The members of this Committee and

others with whom they have spoken having general experience in the area do not know of any such cases. We would suggest that the commercial opportunities for such transactions are remote and that their prevention is not worth the additional complexity added to a statute of general application, particularly if Section 269 continues to be available in abuse situations.

B. "Stock" and "Participating Stock" Section 382(c)

The Committee believes that a single definition should be substituted for the present "stock" and "participating stock" definitions of new Section 382(c). The dual provisions, apparently intended to solve a particular problem, are unnecessary. In the Committee's view, the Commissioner's power to distinguish between real and apparent equity interests by regulation is sufficient to prevent abuse. The dual approach not only adds significant bulk to the statute but also generates a new set of esoteric problems in distinguishing between the overlapping concepts of "stock" and "participating stock".

Apparently the concept of "participating stock" made its appearance here because of concern that, under prior law, voting but otherwise orthodox preferred stock could be given to shareholders of the loss company in a reorganization

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without any resulting limitation on the loss carryovers of such corporation.* Since the voting preferred stock was considered "stock", the losses would carry over if the value of such preferred stock met the 20 percent requirement, even though the loss corporation shareholders were apparently considered to have received no real equity participation in the continuing enterprise.

Perhaps the use of both the "stock" and "participating stock" concepts was designed to preclude the reverse situation, where new interests might somehow purchase orthodox voting preferred stock of a loss corporation in order to avail themselves of its loss carryovers. If receipt of such stock in a reorganization is insufficient to allow continuance of the carryovers, however, it is difficult to see why purchase of such stock in the reverse situation should preclude use of the carryovers. We think a particular equity interest should either be of a type which is taken into account or not, and the power of the Commissioner to issue regulations realistically categorizing particular and unusual situations should be sufficient to prevent abuse.

The statute at present will require every corporation with more than ordinary common stock outstanding to

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* Sen. Rep. No. 94-938, 94th Cong., 2 Sess. 450.

analyze each transaction not only in terms of changes in overall ownership but also to distinguish changes in stock interests from changes in participating stock interests. In many instances it can be expected that it will be very difficult to distinguish stock from participating stock, since the definition of participating stock is quite unclear and overlaps to an uncertain extent with the definition of stock.

Under one possible reading of the definition of participating stock, the only stock which is not also participating stock is voting preferred stock with a fixed liquidation preference and dividend rate. If that was intended, the statute could have expressed this thought more directly by simply so stating.

There are other difficulties with the definition of "participating stock". For example, if stock represents an interest in assets which is limited in the specified manner but the interest in earnings is not so limited, or vice-versa, is the stock participating stock?* Similarly, if the stock is limited by any one of the types of formulas enumerated but not by any of the others, it appears the

* Note 30 at page 202 of the Blue Book, stating that a participating preferred stock may or may not be participating stock, does not clarify the ambiguity.

stock would not be participating stock. It is easy, however, to imagine limitations of the specified type which would in no way realistically preclude participation in the growth of the corporation. For example, a limitation expressed as a multiple of paid in capital would satisfy the requirement of the provision, yet contain a real element of participation. Finally, the definition of participating stock is ambiguous as to the status of convertible stock or debt. There is a substantial sense in which the interest in earnings and assets represented by convertible stock or debt is not limited by any one of the formulas enumerated.

As compared to the participating stock definition, the definition of "stock" ("all shares of stock, except stock which ... does not participate in corporate growth to any significant extent ...") appears to be a better articulation of what was apparently intended as a similar concept, particularly when combined with the other elements of the definition. In addition, the concept has the advantage of having been used before.*

The need to resolve all the ambiguities involved in determining whether an instrument is stock or participating stock, as well as in determining whether it is stock in the first place, is not apparent to the Committee.

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* See Treas. Reg. § 1.305-5.

We believe it should be possible to develop a single definition based on the present definition of stock (treating conventional voting preferred stock in whatever way is desired) which, combined with the power to prescribe regulations realistically evaluating particular instruments, should be sufficient to resolve substantially all of the problems in this area.

To summarize, the cause of simplification is hardly served by introducing the unsatisfactory concept of "participating stock" for the relatively narrow purpose of backstopping a provision aimed at a relatively rare abuse under a single section of the Code.

C. Types of Acquisition Covered by Section 382(a) - Sections 382(a)(1)(C) and 382(a)(5).

Section 382(a) could be greatly simplified by providing that all increases in the percentage ownership by the specified persons other than those increases arising out of reorganizations or pursuant to certain enumerated exceptions are to be taken into account. At present, Section 382(a)(1)(C) covers, with the exception of reorganizations, the vast majority of circumstances under which a direct or indirect interest in stock of a corporation may be increased. Yet Section 382(a)(5) provides a set of exceptions which do not correlate well with the transactions covered by Section 382(a)(1)(C).

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Very few transactions other than reorganizations are excluded from Section 382(a)(1)(C), and to some extent the exclusions may have been partly inadvertent. For example, Section 382(a)(1)(C) covers a purchase of an interest in either a trust or a partnership which owns stock. While an acquisition by or liquidation of a partnership is covered, acquisitions by, and liquidations of, trusts are not. The reason for the difference is not apparent. Similarly, while the liquidation of a partnership is covered, the liquidation of a corporation owning stock in the loss corporation is not covered. In both cases, the appropriate test would appear to be whether the transaction results in a change in indirect ownership. Under the statute, as written, however, a nonprorata liquidation of a partnership would be taken into account, whereas a nonprorata liquidation of a corporation would not.

Aside from these types of indirect changes in ownership, it is difficult to envision many types of changes in stock ownership which would not be taken into account under Section 382(a). A transfer of stock for services might be one such case. A gift or inheritance of stock would be another, but such acquisitions of stock would generally be excluded by Section 382(a)(5)(B).

Accordingly, the Committee recommends that Section

382(a)(1)(C) be amended by deleting its enumeration of specified types of transactions, and that Section 382(a)(1)(B) and (C) be revised to apply in all instances where there are increases in percentage ownership except in the case of reorganizations and except as otherwise specifically excepted in Section 382(a)(5).

The approach suggested by the Committee would allow deletion of the definition of the term "purchase" in Section 382(a)(4), but would require addition of a Section 303 redemption exception in Section 382(a)(5).

Whether or not this suggestion is adopted, Section 382(a)(5) should be redrafted. It is now too narrowly worded since it only excludes transactions which are "acquisitions." Section 382(a)(1)(C) however reaches almost all indirect increases in percentage interest. For example, assume that Father and Son own 70 and 30 percent, respectively, of a corporation's stock and that all of Father's stock is exchanged for non-voting preferred stock in a recapitalization. It would appear that none of the exceptions provided by Section 382(a)(5) are applicable since neither Father nor Son has made an "acquisition." This weakness in the statute might be eliminated by amending the prefatory language of Seccion 382(a)(5) to refer to any increase in percentage points arising from the transactions specified therein.

D. Minimum Ownership Rule - Section 382(a)(3)

The first sentence of this provision is intended to avoid reduction of carryovers from a year in which there has been substantial continuity of ownership during the last half of the year. It has been questioned whether the provision works properly. See Association of the Bar of the City of New York, Committee on Taxation, "Statement on Section 806(e) of the Tax Reform Act of 1976" at 7. We question whether this concept is worth the effort. In a particular case the loss might be incurred entirely in the first half of the year prior to a change in ownership which occurred near the end of the first six months. In another case, the loss might be incurred in the second half of the taxable year following a change in ownership in the seventh month. The provision is objectionable because it may well have capricious results and it adds to the Code's complexity; we believe there is no reason to deviate from the taxable year concept. Either the losses in the year a 382(a) increase in ownership occurs should be allowed or they should not.

A second rule of Section 382(a)(3) provides in effect that all changes of ownership during a corporation's first taxable year are to be disregarded. This rule could be more directly expressed by simply stating that Section

382(a) is inapplicable to increases in ownership during a corporation's first taxable year.

E. Certain Stock for Stock Reorganizations - Section 382(b)(5)(A) and (B).

This provision defies interpretation. The Blue Book indicates, however, that the purpose is to cover a "B" reorganization in which less than all of the stock of the loss company is acquired. In a reorganization in which all of the stock is acquired, the general rule of Section 382(b)(1) apparently works properly and no special rule is required. Sections 382(b)(5)(A) and (B) provide special rules, however, to cover cases in which some of the shareholders of the loss corporation do not exchange their shares or in which stock of the loss corporation was acquired by the acquiring company prior to the reorganization. In general, such stock would be added to the stock received by the old shareholders for purposes of the 40 percent test. However, stock held by the acquiring corporation would not be included if acquired in a transaction covered by Section 382(a) within a 36 month period ending on the date of the exchange. Sections 382(b)(5)(A) and (B) might be simplified to read as follows:

> (A) REORGANIZATIONS IN WHICH NOT ALL STOCK OF THE LOSS CORPORATION IS EXCHANGED. In computing percentages under subparagraphs (1)(B) and (2), the value of stock [and participating stock] not exchanged (valued on the

same basis as the stock exchanged) shall be combined with the value of the stock [and participating stock] received by the shareholders of the loss corporation in the reorganization, except to the extent such stock [or participating stock] was acquired by the acquiring corporation within 36 calendar months prior to the exchange in a transaction described in paragraph (a)(1) and not excepted by paragraph (a)(5).

F. Practical Difficulties in Determining Ownership.

As now drafted, new section 382(a) requires that a corporation determine both the actual and the constructive ownership of its shares. New section 382(b) by and large does not require this determination, since for the most part, a determination can be based on the number of new shares issued in the reorganization involved. However, the Committee has suggested that the ownership concepts of sections 382(a) and 382(b) should be similar.

For closely held corporations, determinations of actual or constructive ownership, while possibly complex, involve facts that are known or can be determined. However, a large proportion of the shares of many public corporations is held in street name, and the corporation's records do not indicate the actual ownership of shares, much less constructive ownership. In the Committee's experience, it is very difficult, if not impossible, to obtain accurate information in such cases.* For example, brokerage houses and trust

* The problem is made more acute by the increase from ten to fifteen in the number of "largest" shareholders whose increases in ownership are taken into account under Section 382(a).

companies frequently will not disclose for whom they hold stock. We therefore suggest that a corporation should be able to rely on record ownership when it does not know and has no reason to know the actual ownership of its shares.* Alternatively, a corporation whose stock is publicly traded might be authorized to ignore any change of ownership not of record and of which it does not have actual knowledge if that change has not been reported pursuant to Section 13(d) of the Securities and Exchange Act of 1934 or similar provisions.** Section 13(d) provides that any person (or group of persons) acquiring a 5 percent interest in any class of a corporation's equity securities, or increasing an existing 5 percent interest, must report such ownership.

IV. Conclusions

1) The Committee believes that while there were problems and anomalies inherent in Section 382 as it existed before the Tax Reform Act, no compelling reasons or evidence have been adduced for its replacement by a provision of such increased length and complexity, notwithstanding the increase

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* A similar approach is used in determining ownership of regulated investment companies and REITS. See Treas. Reg. §§1.852-6,7; 1.857-6,7.

** Additional reporting requirements would be imposed under both proposed Section 13(g) of the Securities and Exchange Act of 1934 (S. 305, 95th Cong., 1st Sess. (1977)) and the amendment to Rule 17a-3(a)(9) under that Act which has been proposed by the Securities and Exchange Commission.

in the carryover period for net operating losses to seven years.

2) Since Section 382 limits the ability to utilize losses and other tax benefits only in those limited circumstances in which a taxpayer does not have other offsetting income, and since the objectionable "windfall" element of "trafficking" in loss carryovers and other tax benefits arises primarily from doubts as to availability of such carryovers, we believe that fresh consideration should be given to whether it is necessary or desirable to limit the transfer of such carryovers.

3) If it is concluded that limitations on the transfer of carryovers are required and that existing Section 382 is inadequate, our principal recommendations would be:

(a) The steps taken in the Tax Reform Act to make Sections 382(a) and 382(b) more parallel are a start in the right direction, but further progress should be made. In particular, the effects of these two provisions on multi-tiered corporate structures should be the same and the exceptions contained in Section 382(a)(5), particularly with respect to transfers within attribution groups, should be made applicable to Section 382(b). Consideration should be given to combining Sections 382(a) and (b) into a single test along the lines of the draft contained

in Appendix A. Furthermore, the exceptions of Section 382(a)(5) should be incorporated into Section 269(b).

(b) Section 382 should not apply to limit the use of carryovers of a specific business against tax liabilities generated by that same business, provided that a taxpayer meets a strict burden of proof if it wishes to take advantage of this exception.

(c) The statute can and should be substantially simplified, even at the cost of some loss of precision. The 3-1/2 - 1-1/2 percent non-linear reduction is an example of an unnecessary complication. The dual definition of "stock" and "participating stock" promises to create difficulties in interpretation out of all proportion to its usefulness. The text makes a number of other suggestions for simplification.

(d) Any amendments dealing with carryovers should be a part of an overall effort to rationalize the various tax provisions which apply in the area. The attempt to deal with Section 269 in the legislative history is unsatisfactory, both in that it is non-statutory and also in that its meaning is unclear. Built-in losses should be dealt with by statute, but only in cases where the potential for abuse is substantial. The present provisions of the consolidated return regulations concerning carryovers and built-in losses bear no relation

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to Section 382 as amended, are susceptible to manipulation, and could be largely eliminated if the other recommendations made in this and the preceding paragraphs are accepted.

(e) Further consideration should be given to the problems of determining changes of ownership of stock of publicly held corporations.

APPENDIX A

SECTION 382 SPECIAL LIMITATIONS ON NET OPERATING AND BUILT-IN LOSSES

(a) Loss of Deduction. If there is a change of more than 60 percent in the ownership of stock of a corporation (or a successor corporation to which Section 381 applies) during a taxable year other than its first taxable year, then, except as provided in subsection (g), any net operating loss carryovers and any built-in loss from such taxable year and prior taxable years shall be reduced by 2 1/2 percent for each percentage point by which such change exceeds 60 percent.

(b) Change in Ownership. A change in stock ownership shall be measured by subtracting (i) the percentage of the total fair market value of the stock owned at the beginning of the taxable year by each person whose percentage has increased by the end of the taxable year, from (ii) the percentage of the total fair market value of the stock owned by each such person at the end of the taxable year, except that changes arising from, and stock issued pursuant to, the following transactions shall not be taken into account:

(1) transfers of shares between persons who are each actual or constructive owners of such shares;

(2) transfers by gift, will, or the laws of descent and distribution;

(3) transfers to creditors in exchange for relinquishment of a claim, provided the claim was acquired in the course of acting as a lender or creditor and not for the purpose of acquiring the stock;

(4) transfers to a person continuously employed by the corporation prior to the transfer for the lesser of 36 months or the period of the corporation's existence;

(5) transfers to a trust described in Section 401(a) exempt from tax under Section 501(a) or to an employee stock ownership plan described in Section 301(d) of the Tax Reduction Act of 1975, provided that such trust or plan is primarily for the benefit of employees of the corporation or of a controlled group of corporations

(within the meaning of Section 1563 (a) determined without regard to Section 1563(a)(4) and (e)(3)(C)) which includes such corporation; and

(6) redemptions described in Section 303.

(c) Constructive Ownership. Section 318 (relating to constructive ownership) shall apply in determining the ownership of stock, except that Sections 318(a)(2)(C) and (3)(C) shall be applied without regard to the 50 percent limitation therein, and except that a corporation may rely on record ownership unless the facts and circumstances are such that any director, officer, or owner of 5 percent of the value of the stock knows, or has reason to know, the actual identity of the owners of such shares.

(d) Changes Pursuant to a Plan. Changes in ownership commencing in one or more prior taxable years which the Commissioner establishes are pursuant to a single plan, whether formal or informal, to circumvent the limitations of this section by lengthening a period of change of ownership shall be aggregated in determining the change in ownership for the taxable year.

(e) "Stock". The term "stock" means all stock, except that which --

(1) is fixed and preferred as to dividends and does not participate in corporate growth to any significant extent,

(2) has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par value), and,

(3) is not convertible into another class of stock.

The Secretary shall prescribe regulations under which, by reason of conversion and call rights, rights in earnings and assets, priorities and preferences as to distributions or earnings or assets and similar factors, stock, warrants or convertible securities shall be treated as stock, or stock (however defined) shall not be treated as stock.

(f) "Built-In Loss". [Insert definition based on consolidated return regulations, but limited to cases where basis of all assets acquired is at least 50 percent higher than consideration attributable thereto.]

(g) Exception. The limitations of this section shall not apply to the extent that the taxpayer demonstrates, pursuant to regulations prescribed by the Secretary and by clear and convincing evidence, that a operating loss or a built-in loss is applied to the taxable income from a continuing trade or business which generated such loss.

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The provisions of the consolidated return regulations limiting losses following the acquisition by a new common parent, a reverse acquisition and a CRCO would be withdrawn.

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